[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION
OF THE
ECONOMIC RECOVERY TAX ACT OF 1981
(H.R. 4242, 97TH CONGRESS; PUBLIC LAW 97-34)

PREPARED BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION

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LETTER OF TRANSMITTTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., December 29, 1981.

Hon. DAN ROSTENKOWSKI, *Chairman,*
Hon. ROBERT DOLE, *Vice Chairman,*
Joint Committee on Taxation,
U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: A committee report of a Congressional committee sets forth the committee's explanation of a bill as reported by that committee. In some instances, a committee report cannot also be referred to as an explanation of the final provisions of the legislation enacted by the Congress. This is because the versions of the bill reported by the House and Senate committees may differ significantly from versions of the bill passed by the House, passed by the Senate, or enacted after action by a conference committee.

The Economic Recovery Tax Act of 1981 (Public Law 97-34), because of its comprehensive scope and the numerous changes which were made to the reported versions of the bill by the House, the Senate, and the conference committee, is an example of legislation with respect to which the differences between provisions of the reported bills and provisions of the public law are particularly significant. This document represents an explanation of the Economic Recovery Tax Act of 1981 as enacted.

This document was prepared by the staff of the Joint Committee on Taxation, in consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance. It is comparable to similar material prepared by the Joint Committee staff with respect to other revenue acts in recent years.

The first part of the document is an overall chronology of the legislative background of the Act in the 97th Congress. (In addition to this overall chronology, specific references to the legislative background of each provision of the Act are set forth in footnotes accompanying the explanations of the provisions in the fourth part of the document.) The second part is a brief summary of the principal provisions of the Act. The third part presents the general reasons for the legislation. The fourth part consists of explanations of the provisions of the Act in the order in which they appear in the public law. The fifth part sets forth the estimated revenue effects of the Act for fiscal years 1981–1986 and for calendar years 1981–1986. The Appendix shows the new individual income tax rate schedules under the Act for 1982, 1983, and 1984 and thereafter.

Sincerely yours,

MARK L. MCCONAGHY,
Chief of Staff.

I. LEGISLATIVE HISTORY OF THE ACT

The following is an overall chronology of the legislative background in the 97th Congress of the Economic Recovery Tax Act of 1981 (Public Law 97-34).[1]

● ***Hearings before the House Committee on Ways and Means,*** Tax Aspects of the President's Economic Program, 97th Cong., 1st Sess.—February 24-25; March 3-5, 24-27, and 30-31; April 1-3 and 7, 1981.

● ***Hearings before the Senate Committee on Finance,*** Tax Reduction Proposals, 97th Cong., 1st Sess.—May 13-14 and 18-21, 1981.

● ***Markup sessions, the House Committee on Ways and Means***—June 10-11, 16-18, and 23-25; July 9-10, 13-16, 21, and 23, 1981.

● ***Markup sessions, the Senate Committee on Finance***—June 10, 18, and 22-25, 1981.

● ***H.J. Res. 266, ordered reported, with amendments, by the Senate Committee on Finance***—June 25, 1981.

● ***S. Rep. No. 97-144 on H.J. Res. 266,*** 97th Cong., 1st Sess.—July 6, 1981.

● ***Senate floor action on H.J. Res. 266, as reported by the Senate Committee on Finance***—July 15-18, 20-24, and 27-29, 1981. On July 29, 1981, H.J. Res. 266, as amended, was agreed to by a record vote of 89-11, and the measure was returned to the Senate Calendar. (See also reference below to July 31 Senate floor action on H.R. 4242, as passed by the House.)

● ***H.R. 4242, ordered reported by the House Committee on Ways and Means***—July 23, 1981.

● ***H. Rep. No. 97-201 on H.R. 4242,*** 97th Cong., 1st Sess.—July 24, 1981.

● ***Hearing before the House Committee on Rules***—July 28, 1981. The rule for consideration of H.R. 4242 was reported on July 28, 1981 (H. Res. 198, H. Rep. No. 97-205, 97th Cong., 1st Sess.).[2]

● ***House floor action on H.R. 4242, as reported by the Ways and Means Committee***—July 29, 1981. The House took the following action with respect to the reported bill: (1) the rule was adopted by record vote of 280-150; (2) the Ways and Means Committee amendment to delete title IX of the reported bill was adopted by voice

[1] In addition to this overall chronology, specific references to the legislative background of each provision of the Act are set forth in footnotes accompanying the explanations of the provisions in part IV of this document. These legislative background references include, as appropriate, citations to the following: H.J. Res. 266, as reported by the Senate Finance Committee; S. Rep. No. 97-144 on H.J. Res. 266, July 6, 1981; Senate floor amendments, if any, to H.J. Res. 266, as reported by the Finance Committee; H.R. 4242, as reported by the House Ways and Means Committee; H. Rep. No. 97-201 on H.R. 4242, July 24, 1981; H.R. 4242, as passed by the House on July 29, 1981 (the Conable-Hance substitute for the Ways and Means bill); and H. Rep. No. 97-215 (S. Rep. No. 97-176), the Conference Report to accompany H.R. 4242, August 1, 1981 (citations in footnotes are to the Joint Explanatory Statement of the Committee of Conference).

[2] The rule provided for consideration of one Ways and Means Committee amendment, and two separate amendments to be offered as substitutes for H.R. 4242 as reported by the Ways and Means Committee. These substitutes were an amendment proposed by Mr. Udall and others (introduced as H.R. 4269), and an amendment proposed by Messrs. Conable and Hance (introduced as H.R. 4260). The committee amendment was to delete title IX of H.R. 4242 (relating to "Loans to State Unemployment Funds").

vote; (3) Mr. Udall's substitute was rejected by a record vote of 144–288; (4) Mr. Conable's substitute was agreed to by a record vote of 238–195; and (5) the bill was passed, as amended, by a record vote of 323–107. H.R. 4242, as passed by the House, was received in the Senate on July 30, 1981 and held at the desk.

● ***Senate floor action on H.R. 4242, as passed by the House***—July 31, 1981. The Senate took the following action on H.R. 4242, as passed by the House: (1) substituted the language of H.J. Res. 266, as amended by the Senate (see above), for the House-passed bill, made an amendment of a technical nature, and passed H.R. 4242 with the Senate amendments by voice vote; (2) insisted on the Senate amendments by voice vote; (3) requested a conference on the bill with the House; and (4) appointed conferees (Senators Dole, Packwood, Roth, Danforth, Long, Byrd of Virginia, and Bentsen).

● ***House floor action on H.R. 4242, as amended by the Senate***—July 31, 1981. The House took the following action on H.R. 4242, as amended by the the Senate: (1) disagreed to the Senate amendments to H.R. 4242; (2) agreed to a conference on the bill with the Senate; and (3) appointed conferees (Messrs. Rostenkowski, Gibbons, Pickle, Rangel, Stark, Conable, Duncan, and Archer).

● ***House-Senate Conference on H.R. 4242***—July 31 and August 1, 1981.

● ***Conference Report to accompany H.R. 4242, with Joint Explanatory Statement of the Committee of Conference***—August 1, 1981 (H. Rep. No. 97–215, S. Rep. No. 97–176, 97th Cong., 1st Sess.).

● ***Senate action on Conference Report***—August 1 and 3, 1981. On August 3, 1981, the Senate agreed to the Conference Report by a record vote of 67–8, after rejecting a motion to recommit by a record vote of 20–55. Also, the Senate passed S. Con. Res. 30, directing the Clerk of the House to make certain technical corrections in the enrollment of H.R. 4242.

● ***House action on Conference Report***—August 4, 1981. The House agreed to the Conference Report by a record vote of 282–95. Also, the House agreed to S. Con. Res. 30, as passed by the Senate.

● ***Enactment***—H.R. 4242 was signed by President Reagan on August 13, 1981 (Public Law 97–34).

II. SUMMARY OF THE ACT

The following is a brief summary of the principal provisions of P.L. 97-34, the Economic Recovery Tax Act of 1981 (the "Act").

Individual Income Tax Provisions

Individual tax rates

The Act provides cumulative across-the-board reductions in individual income tax rates of 1¼ percent in 1981, 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984 and subsequent years. These tax reductions will be reflected in reductions in withholding on October 1, 1981, July 1, 1982, and July 1, 1983.

The top marginal tax rate is reduced from 70 percent to 50 percent beginning January 1, 1982. The maximum tax rate on long-term capital gains is reduced to 20 percent for sales or exchanges after June 9, 1981.

Indexing

The Act adjusts the income tax brackets, zero bracket amount, and personal exemption for increases in the consumer price index, starting in 1985. The first adjustment, for 1985 tax returns, will be based on price increases between fiscal year 1983 and fiscal year 1984.

Deduction for two-earner married couples

The Act allows a two-earner married couple filing a joint return a new deduction in computing adjusted gross income. This deduction equals a percentage of the first $30,000 of qualified income earned by whichever spouse has the lower amount of earnings. In 1982, the percentage will be five percent ($1,500 maximum deduction). In 1983 and subsequent years, the percentage will be ten percent ($3,000 maximum deduction).

Child care credit, exclusion

The Act increases the maximum amount of employment-related expenditures eligible for the child care tax credit from $2,000 to $2,400 for taxpayers with one dependent and from $4,000 to $4,800 for taxpayers with two or more dependents. In addition, the Act increases the rate of the child care credit from 20 percent to 30 percent for taxpayers with incomes of $10,000 or less. The rate of the credit is reduced by one percentage point for each $2,000 of income, or fraction thereof, above $10,000 until the lowest rate (20 percent) is reached for taxpayers with incomes above $28,000.

Also, the Act generally excludes from an employee's gross income amounts paid by an employer for dependent care assistance provided pursuant to a qualified program.

Charitable contributions deduction for nonitemizers

The Act provides a deduction for charitable contributions for individual taxpayers who do not itemize personal deductions.

For 1982 and 1983, the deduction is limited to 25 percent of the first $100 of contributions, or a maximum deduction of $25. For 1984, the contribution cap is raised to $300, or a maximum deduction of $75. (In the case of a married individual filing a separate return, the deduction limitation is one-half of the amounts just stated.) For 1985, the deduction is allowed for 50 percent of contributions, with no cap, and for 1986 the deduction is allowed for 100 percent of contributions. This provision expires after 1986.

Deduction for adoption expenses

The Act provides a new itemized deduction, beginning in 1981, for up to $1,500 of expenses incurred in connection with the adoption of a child who has special needs which make him or her hard to place for adoption.

Gain on sale of residence

The Act extends from 18 months to two years the replacement period during which taxpayers must reinvest the proceeds from the sale of their principal residence in a new principal residence in order to be eligible for rollover nonrecognition treatment on gain from that sale. Also, the Act increases from $100,000 to $125,000 the maximum amount of capital gain on the sale of a principal residence which is excludable from gross income by a taxpayer age 55 or over.

Foreign earned income

The Act replaces the present system of deductions and exclusions for excess costs of living abroad with an exclusion of income earned abroad. The maximum amount excludable from income will be $75,000 in 1982, increasing in $5,000 increments to the permanent level of $95,000 in 1986 and thereafter. In addition, there is an exclusion for excess housing costs.

Capital Cost Recovery Provisions

The Act replaces the prior law depreciation system with the Accelerated Cost Recovery System for most tangible property placed in service after December 31, 1980.

Machinery and equipment

For tangible personal property (principally, machinery and equipment), assets are grouped into four classes with recovery periods of 3, 5, 10, and 15 years. The *3-year class* consists of autos, light duty trucks, equipment used in research and experimentation, other short-lived property, certain racehorses over two years old, and certain other horses over 12 years old. The *5-year class* includes most other equipment, except long-lived public utility property. The *10-year class* includes public utility property with a mid-

point life under the prior asset depreciation range system ("ADR") between 18 and 25 years, railroad tank cars, certain theme park structures, certain mobile homes, and utility coalburning equipment used to replace or convert oil-fired and gas-fired combustors and boilers. The *15-year class* includes public utility property with an ADR midpoint life above 25 years.

Under the Act, statutory schedules of capital cost recovery deductions are provided for each class of recovery property. For each class, one schedule is provided for property placed in service in the years 1981 through 1984. A more accelerated schedule is provided for each class for property placed in service in 1985. For property placed in service after 1985, the schedule for each class is accelerated to a greater extent.

The investment tax credit will be six percent for property in the 3-year class and ten percent for all other eligible property.

Real property

Real property will be written off over a 15-year period using a prescribed schedule of capital cost recovery deductions. A schedule is provided for low-income housing that is more accelerated than the schedule for other real property. If a taxpayer sells nonresidential real property for which the accelerated method has been used, gain will be treated as ordinary income to the extent of all recovery deductions previously taken. If a taxpayer sells residential real property for which the accelerated method has been used, ordinary income recapture will be limited to the excess of the accelerated over straight-line cost recovery. If a taxpayer uses straight-line recovery, all gain will be treated as capital gain.

Other provisions

Businesses may elect to expense up to $5,000 of personal property for taxable years beginning in 1982 and 1983, $7,500 in 1984 and 1985, and $10,000 thereafter. The Act repeals the provision of prior law for additional first-year depreciation, effective for property placed in service after 1980.

The Act raises the amount of used property eligible for the investment credit from $100,000 to $125,000 for taxable years beginning in 1981 through 1984, and to $150,000 for 1985 and subsequent years.

The Act provides a safe harbor rule under which a nominal lessor will be treated as the owner of the property for Federal income tax purposes and thus entitled to the associated cost recovery allowances and investment credits, even if the lessee is the State-law owner of the property.

The Act limits the amount of property eligible for the investment credit to the extent to which the taxpayer is "at risk," that is, has invested the taxpayer's own money or is personally liable for loans. There are, however, exceptions to these rules for nonrecourse loans from financial institutions and other business lenders and for certain energy property.

The Act extends the carryover period for unused net operating losses and investment tax credits from seven to 15 years.

Rehabilitation Expenditures

Three-tier investment credit

The Act replaces the present ten-percent investment credit for expenditures to rehabilitate nonresidential structures, and the amortization and rapid depreciation provisions for certain rehabilitations of certified historic structures, with a three-tier system of investment credits. Under the Act, the credit is 15 percent for rehabilitation of nonresidential buildings 30 to 39 years old, 20 percent for rehabilitation of nonresidential buildings over 39 years old, and 25 percent for certified rehabilitation of certified historic structures. (No credit is allowed for a noncertified rehabilitation of a certified historic structure.) In the case of expenditures to which the 15-percent and 20-percent credits apply, the basis for determining cost recovery deductions is reduced by the amount of the credit. The rehabilitation provisions of the Act generally apply to expenditures incurred after December 31, 1981.

Demolition of certified historic structures

The Act repeals the requirement that taxpayers who demolish or substantially alter certified historic structures must use the straight-line method of depreciation.

Incentives for Research

Tax credit for incremental research expenditures

The Act provides a 25-percent income tax credit for certain qualified research expenditures if incurred in carrying on a trade or business of the taxpayer, to the extent such expenditures exceed a base period amount. This new credit applies to expenditures made after June 30, 1981, and before 1986.

For the credit, the Act adopts the definition of research used for purposes of the special deduction rules under Code section 174, but subject to certain exclusions. A taxpayer's expenditures eligible for the new incremental credit consist of (1) the taxpayer's "in-house" expenditures for research wages and supplies used in research, plus certain expenditures for research use of computers, laboratory equipment, and other personal property; (2) 65 percent of amounts paid for contract research conducted on behalf of the taxpayer; and (3) if the taxpayer is a corporation, 65 percent of grants for basic research to be performed by universities or certain scientific research organizations.

Contributions of research equipment to universities

The Act allows corporations a charitable deduction for contributions of newly manufactured scientific equipment to universities for research use equal to the taxpayer's basis plus 50 percent of the appreciation, but not to exceed twice the basis.

Allocation of research expenditures to U.S.-source income

For two years, taxpayers are required to allocate expenditures for research and experimentation conducted in the United States entirely to U.S.-source income.

Other Business Provisions

Corporate rate reduction

The Act reduces the tax rate on the first $25,000 of corporate taxable income from 17 percent to 16 percent in 1982 and 15 percent in subsequent years. The Act also reduces the rate on the next $25,000 of taxable income from 20 percent to 19 percent in 1982 and 18 percent in subsequent years.

Incentive stock options

The Act reinstates certain nonrecognition rules and capital gains characterization with respect to employee stock options which meet certain conditions ("incentive stock options"). Under these rules, no gain or loss is recognized by the employee, and no deduction is allowed to the corporate employer, when the option is granted or when the option is exercised. Also, the employee is allowed capital gains treatment on any gain on the sale of the stock.

The aggregate value of stock subject to incentive stock options for an employee in a calendar year is limited to $100,000. However, employees are allowed a three-year carryover of up to $50,000 if they do not use the full $100,000 in any one year. In the case of options granted before 1981, the aggregate value of stock which an employee may treat as subject to incentive stock options cannot exceed $50,000 per year and $200,000 in the aggregate.

Targeted jobs credit

The Act extends the targeted jobs tax credit through 1982. It adds AFDC recipients and WIN registrants as additional targeted groups, as well as Vietnam veterans age 35 or over and employees laid off from CETA programs. It limits the credit for cooperative education students to the economically disadvantaged. Also, the Act requires the employer to request or obtain certification of employee eligibility before the employee begins work and makes a number of other modifications to the rules for administration of the credit.

Accumulated earnings credit

The Act increases from $150,000 to $250,000 the amount which a corporation may accumulate, without showing a business purpose, that is exempt from the accumulated earnings tax, effective for post-1981 taxable years.

Subchapter S corporations

The Act increases the maximum number of shareholders for a subchapter S corporation from 15 to 25 and allows certain trusts to be qualified shareholders, effective for post-1981 taxable years.

Inventory accounting

The Act simplifies LIFO inventory accounting for small businesses. Businesses with annual average gross receipts of less than $2 million for the prior three years are allowed to use a single dollar-value LIFO pool, and taxpayers switching to LIFO are given three years to take into income the inventory writedowns from prior years. Also, the Treasury Department is directed to issue rules to

simplify the use of dollar-value LIFO inventory accounting through the use of published government indices.

Savings Incentives

Interest and dividend exclusion

The Act limits to 1981 the applicability of the $200 interest and dividend exclusion ($400 for a joint return). Effective for 1982 and later years, the Act provides a $100 exclusion for dividends only (with $200 excludable on a joint return regardless of which spouse earns the dividends). Starting in 1985, individuals also will be able to exclude 15 percent of interest income to the extent such income exceeds nonbusiness and nonmortgage interest deductions, up to a maximum interest exclusion of $450 ($900 for joint returns).

Qualified savings certificates

The Act excludes from income interest on qualified savings certificates, not to exceed an aggregate amount of $1,000 ($2,000 for a joint return).

These one-year certificates must be issued after September 30, 1981, and before January 1, 1983, and must have a yield exactly equal to 70 percent of the yield on 52-week Treasury bills. The certificates must be issued by credit unions or by certain financial institutions which must use the proceeds to provide residential-related financing or agricultural loans.

Individual retirement accounts

The Act increases the limit on deductions for contributions to individual retirement accounts from the lesser of 15 percent of compensation or $1,500 ($1,750 for a spousal IRA) to the lesser of 100 percent of compensation or $2,000 ($2,250 for a spousal IRA). Also, the Act allows an active participant in an employer-sponsored plan to deduct up to $2,000 of voluntary employee contributions to the plan or to an IRA. These IRA changes are effective for taxable years beginning after 1981.

Under the Act, an amount in an IRA (or in an individually directed account in a qualified plan) which is used to acquire coins, antiques, art, stamp collections, or other collectibles after December 31, 1981, is taxed to the individual.

Self-employed retirement savings

The Act increases from $7,500 to $15,000 the maximum annual deduction for a contribution to a self-employed retirement plan (Keogh or H.R. 10 plan), and for employer contributions to a simplified employee pension, and makes other changes in tax rules applicable to such plans, generally effective for taxable years beginning after 1981.

Employee stock ownership plans

The Act terminates after 1982 the additional investment tax credit for contributions to an employee stock ownership plan (ESOP), and substitutes an income tax credit for contributions to an ESOP which is based on employee payroll. For 1983 and 1984, the credit is limited to one-half of one percent of compensation paid

to employees under the plan; the limitation increases to three-fourths of one percent after 1984. The payroll-based ESOP credit expires at the end of 1987.

Dividend reinvestment plans

The Act excludes from income up to $750 ($1,500 for a joint return) of stock distributions from public utilities which are reinvested in the stock of the utility under a qualified dividend reinvestment plan. When the taxpayer sells the stock, gain generally will be treated as capital gain. The exclusion applies for the years 1982 through 1985.

Estate and Gift Tax Provisions

Unified credit

The Act increases the unified credit against the estate and gift taxes. As a result, the amount of cumulative transfers exempt from these taxes increases from $175,625 under prior law to $225,000 for gifts made and estates of decedents dying in 1982, $275,000 in 1983, $325,000 in 1984, $400,000 in 1985, $500,000 in 1986, and $600,000 in 1987 and subsequent years.

Rate reduction

The Act reduces the top estate and gift tax rate from 70 percent to 65 percent for gifts made and estates of decedents dying in 1982, 60 percent in 1983, 55 percent in 1984, and 50 percent in 1985 and subsequent years.

Marital deduction

The Act removes the quantitative limits on the marital deduction under both the estate and gift taxes so that no transfer tax is imposed on transfers between spouses. Also, the Act makes certain terminable interests eligible for the marital deduction and makes such interests includible in the surviving spouse's gross estate.

Current use valuation

The Act increases the maximum amount by which the gross estate may be reduced under the current use valuation rules from $500,000 to $600,000 for decedents dying in 1981, $700,000 in 1982, and $750,000 in 1983 and subsequent years. It also makes a number of technical changes intended to liberalize the current use valuation rules.

Gift tax exclusion

The Act increases from $3,000 to $10,000 the annual exclusion from the gift tax for gifts to a single donee. It also provides an unlimited exclusion for certain gifts made to pay for qualifying medical expenses and school tuition.

Other provisions

The Act makes a number of other modifications to the estate and gift tax rules, including repeal (for most purposes) of the rule that gifts made by a decedent within three years of death must be included in the decedent's gross estate; liberalization of the rules

allowing deferral of the estate tax attributable to closely held businesses; elimination of a step-up in basis if appreciated property is acquired by gift by the decedent within one year of the decedent's death and then is returned to the donor or the donor's spouse; repeal of the orphan's exclusion; annual filing of gift tax returns; one-year extension of the transition rule for certain wills or revocable trusts under the tax on generation-skipping transfers; and allowance of a charitable deduction for estate and gift tax purposes for certain bequests or gifts of copyrightable works of art, etc., when the donor retains the copyright.

Tax Straddles

Gain or loss on straddles

The Act requires that commodity futures contracts must be marked to market at the end of each year (or immediately prior to disposition) and treated as if 60 percent of the capital gains and losses on the contracts were long-term and 40 percent were short-term. It provides a three-year carryback for losses on mark-to-market assets. Under a transition rule, tax due on gains rolled forward from prior years into 1981 may be paid in five annual installments with interest.

For straddles involving property other than futures contracts, losses are generally allowed only to the extent that the amount of the loss exceeds the unrealized gains on offsetting positions. Other losses are deferred, and the wash sale and short sale principles of present law are extended to straddles.

Interest and carrying charges

The Act requires that interest and carrying charges for investments in commodities and other personal property be capitalized if the investments are part of a straddle.

Hedging

The Act exempts certain hedging transactions from the mark-to-market, loss deferral, and capitalization rules.

Treasury bills

The Act treats Treasury bills (and other short-term government obligations) as capital assets. Under the Act, gain from the sale or exchange of a Treasury bill, to the extent of the earned ratable share of the market discount to the taxpayer, is ordinary income.

Dealer identification of securities

The Act requires dealers in securities to identify securities as held for investment on the date of acquisition. A seven-day look-back applies to floor specialists with respect to the stocks for which they are registered specialists.

Sale or exchange of capital assets

The Act provides that taxable dispositions of capital assets are treated as sales or exchanges.

Windfall Profit Tax Provisions

Royalty owner credit and exemption

For 1981, royalty owners are allowed a credit against the first $2,500 of windfall profit tax liability. For 1982 through 1984, the Act provides an exemption from the windfall profit tax for up to two barrels a day of royalty production. After 1984, there is an exclusion for up to three barrels a day.

Stripper oil exemption

The Act exempts from the windfall profit tax stripper oil produced by independent producers, starting in 1983.

Newly discovered oil tax rate

The Act reduces the windfall profit tax rate on newly discovered oil from 30 percent to 27.5 percent in 1982, 25 percent in 1983, 22.5 percent in 1984, 20 percent in 1985, and 15 percent in subsequent years.

Exemption for certain charities

The Act exempts from the windfall profit tax qualified production owned by orphanages and similar charitable organizations.

Administrative Provisions

Interest on deficiencies and overpayments

The Act provides that the interest rate applicable to tax deficiencies and overpayments is to be set annually at the average prime interest rate for September.

Penalty for valuation overstatements

The Act provides an additional penalty, applicable with respect to returns filed after 1981, in the case of underpayments of income tax which result from an overstatement of valuation of property made by an individual or certain other taxpayers, subject to certain exceptions and waiver provisions.

Other administrative provisions

The Act makes certain increases in penalties for negligence, filing false withholding certificates, failure to file information returns (or furnish copies to payees), and overstated tax deposits. Also, the Act provides for confidentiality of Internal Revenue Service information used to develop standards for auditing tax returns. The Act authorizes an increased fee for filing petitions with the U.S. Tax Court.

Corporate estimated tax payments

The Act increases the minimum amount of the current year's tax liability which large corporations must pay currently through estimated tax payments, regardless of their prior year's tax liability, from 60 percent to 65 percent in 1982, 75 percent in 1983, and 80 percent in subsequent years.

Individual estimated tax payments

The Act increases the threshold for payment of estimated taxes for individuals from $100 to $500, over a four-year period.

Railroad retirement tax

The Act increases the railroad retirement tax on employers from 9.5 percent to 11.75 percent and provides for a new tax of two percent on the compensation of employees. A number of other technical changes are made to the railroad retirement program.

Miscellaneous Provisions

Installment sales of land

The Act places an upper limit on the interest rate the Internal Revenue Service may impute on certain installment sales of land between related parties.

Business travel expenses of State legislators

The Act allows State legislators to treat their district residence as their tax home and to treat as business expenses an amount equal to the greater of the Federal per diem or the State per diem, with certain limitations, and without regard to the "away-from-home" rule. The changes apply to taxable years beginning after December 31, 1975.

Tax rate on principal campaign committees

The Act allows the principal campaign committee of a Congressional candidate to pay corporate income tax at graduated rates on its taxable income for taxable years beginning after 1981.

Reorganizations of thrift institutions

The Act provides special rules relating to tax-free reorganizations of financially troubled thrift institutions.

Bad debt deduction of commercial banks

For 1982, the Act increases from 0.6 percent to 1.0 percent the percentage of eligible loans which limits the bad debt deduction of commercial banks under the percentage of outstanding loans method.

Tax treatment of mutual savings banks converting to stock associations

The Act contains rules to facilitate conversions of mutual savings banks into stock associations.

Restricted property

The Act postpones recognition of income and deductibility as compensation, absent an employee election, when property subject to certain restrictions on transferability imposed by the Securities Exchange Act of 1934 (or SEC accounting rules) is transferred to an employee as compensation, effective for taxable years ending after 1981.

Amortization of construction period interest and taxes

The Act permanently exempts low-income housing from the requirement that interest and taxes paid during the construction period of a building be capitalized.

Amortization of low-income housing rehabilitation expenditures

Under certain limited circumstances, the Act raises from $20,000 to $40,000 the maximum amount of expenditures (made after 1980) eligible for five-year amortization in connection with the rehabilitation of low-income housing.

Corporate charitable contributions

The Act increases, from five percent to ten percent of taxable income (computed with certain modifications), the limit on the deduction for charitable contributions by corporations, effective for taxable years beginning after 1981.

Deductibility of certain business gifts to employees

The Act increases the ceiling on deductibility by an employer of business gifts of tangible personal property to its employees, and expands the purposes for which such awards may be given, effective for taxable years ending on or after the date of enactment of the Act.

Motor carrier operating rights

The Act allows taxpayers who held motor carrier operating rights on July 1, 1980 to amortize the basis of those rights over a 60-month period. This provision applies to taxable years ending after June 30, 1980.

Production credit for natural gas

The Act amends the production credit for certain kinds of natural gas to coordinate the credit with elections provided under the pricing provisions of the Natural Gas Policy Act of 1978.

Moratorium on fringe benefit regulations

The Act extends through December 31, 1983 the moratorium on issuance of Treasury regulations relating to the income tax treatment of fringe benefits.

Group legal services plans

The Act extends through 1984 the present exclusion from an employee's income for employer contributions to, and benefits provided under, qualified group legal services plans and the tax exemption of trusts under such plans.

Tax-exempt bond provisions

The Act provides tax exemption for interest on certain bonds issued by volunteer fire departments and for interest on bonds used to purchase leased mass transit facilities.

Telephone excise tax

The Act extends the telephone excise tax at a one-percent rate for 1983 and 1984.

FUTA tax on certain fishing boat wages

The Act provides that, during 1981, wages paid to fishing boat crew members who are self-employed for purposes of FICA and income tax withholding are not subject to FUTA taxes.

Payout rule for private foundations

The Act modifies the distribution requirements for private foundations. For taxable years beginning after 1981, a private foundation must annually distribute for charitable purposes an amount equal to five percent of the value of net investment assets (but is not required to distribute any excess of the amount of its net income over this investment return amount).

Foreign investment in U.S. real property

The Act makes a series of technical changes to the tax on capital gains recognized by foreign investors on dispositions of U.S. real estate.

Foreign investment company rules

The Act modifies the rules relating to taxation of gain from disposition of stock in a foreign investment company by excluding from those rules gain attributable to earnings and profits derived before the foreign corporation became a foreign investment company.

III. GENERAL REASONS FOR THE ACT

Overview

The Congress concluded that a program of significant multi-year tax reductions was needed to ensure economic growth in the years ahead. This tax reduction program should help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy, lower personal tax burdens, and restrain the growth of the Federal Government. Lower tax burdens on individuals and businesses, maintained over a period of years, should help restore certainty to economic decision-making and provide a sound basis for a sustained economic recovery. Accordingly, the Congress chose a program of broadly based tax cuts that it believed would improve incentives to work, produce, save, and invest, consistent with the goal of eliminating the Federal budget deficit by 1984.

The Congress was concerned that the performance of the economy had fallen far below its potential and that this condition would continue if there was no change in policy. The real growth of the economy, which had slowed in 1978 and again in 1979, came to a halt in 1980. Inflation and interest rates rose to exceptional levels and remained high. The unemployment rate rose sharply in 1980 and remained unacceptably high, while rates of productivity and savings declined or stagnated.

At the same time, Federal budget receipts have grown to be a larger percentage of the income generated by the American economy than at any other time in the postwar period. Without significant tax cuts, Federal taxes would have risen to 22.8 percent of the gross national product by 1984. The Congress believed that this level of taxation would have been a significant impediment to economic progress and that an extensive program of tax cuts was required at this time.

Also, Federal spending had grown from 19.5 percent of gross national product in fiscal year 1974 to 22.6 percent in fiscal year 1980. In consequence of these increased expenditures, the Federal Government has too often intruded into decisions on the allocation of resources. Such intrusions have caused inefficiencies in the workings of the economy, misallocation of resources, uncertainty, and instability. As a result, the free enterprise system has fallen short of its potential for economic growth. The Congress believed that its program of tax reductions would increase the likelihood that Federal spending would be restrained over an extended period of time and would speed economic recovery by reducing governmental interference in the workings of the economy.

Individual Income Tax Reductions

The interaction of the progressive income tax rate structure with the inflation of the past several years has caused a significant

increase in individual income taxes, far in excess of the tax reduction which was enacted in 1978. The Congress believed that excessively high income taxes give households too little control (and the Federal Government too much control) over the disposition of their earnings. The proportion of household income that is paid in individual income tax is now greater than at any other time in recent decades. Without a change in policy, this proportion would automatically have risen in future years, because of the interaction of inflation and the fixed dollar amounts in the present tax rate schedules. The Congress concluded that these automatic increases should be forestalled by multi-year tax cuts, followed by automatic indexation of the tax brackets and other fixed dollar amounts.

A second reason for individual tax reductions was to mitigate the adverse effects of high marginal tax rates on productivity and savings. A high marginal tax rate—that is, the tax rate applicable to the last dollar of income—discourages additional work effort and encourages tax avoidance by diverting taxpayers from more productive activities that are fully taxable to less productive activities that are not fully taxable or that generate tax losses which can be used to shelter other income from tax.

Marginal income tax rates are now higher than they have been at any other time in recent decades. Today, more than half of all income is received by taxpayers whose marginal income tax rate exceeds 30 percent. Moreover, without a change in policy, inflation would have caused marginal tax rates to increase automatically in future years. The Congress concluded that these marginal income tax rates should be lowered for all taxpayers by multi-year cuts in tax rates.

Third, tax changes were needed to reduce the tax penalty which resulted when two persons with relatively equal incomes married each other. Imposing substantial tax penalties on marriage is undesirable, because such penalties imply a lack of concern on the part of the government for the family. These penalties also discourage work effort by second-earners and undermine respect for the tax system itself as an even-handed way to raise revenue. Accordingly, the Act is designed to achieve significant reductions in this marriage penalty.

The Congress concluded that the appropriate size of the income tax reduction for individuals was $4 billion for calendar year 1981, $42 billion for calendar year 1982, $85 billion for calendar year 1983, and $120 billion for calendar year 1984. The Congress believed that these amounts represented significant progress toward the goals of tax reduction.

Capital Formation Tax Reductions

The tax system in effect prior to the Act created significant disincentives to investment. Business investment in new plant and equipment is crucial for increasing worker productivity, which holds down the rate of inflation and improves the nation's competitiveness in international trade. Yet, investment spending in excess of that needed to replace worn-out plant and equipment has been too small in recent years, and an increasing share of that spending has been for satisfaction of governmentally mandated requirements and thus has not necessarily augmented capacity to produce. Ac-

cordingly, the Congress concluded that tax reductions were urgently needed to stimulate capital formation.

In hearings on tax reduction, the tax-writing committees heard numerous witnesses testify that a restructuring of depreciation allowances for tax purposes would be an effective way of stimulating capital formation. Inflation reduces the tax savings from depreciation deductions because the value of the dollar is less when these deductions are claimed than it was when the investment was originally made. As a result, under the prior law system of depreciation, inflation had reduced the incentive to invest.

The Congress agreed that a new system of capital cost recovery was required and the Act, therefore, provides for more accelerated depreciation of plant, equipment, commercial buildings and rental housing. This will provide incentives for investment spending and will contribute immediately to cash flow for the financing of such spending. In addition, the new system is designed to simplify compliance by taxpayers and administration by the Internal Revenue Service.

The Congress also was concerned that the nation's lead in research and development has been diminished in recent years. From research and development come technological advances that are essential to increased productivity and competitiveness. The Congress believed that major new tax incentives were needed to encourage additional research and development.

The Congress concluded that the tax system should be modified to promote greater personal savings, so that the rebuilding of the economy could occur with less risk of inflation and so that individuals could more easily accumulate their own resources for retirement. The Act, therefore, provides incentives for individuals to make greater contributions to private retirement accounts and to a new type of savings certificate. It extends tax incentives for individual retirement accounts to a much broader class of taxpayers. The Act also contains incentives for the wider use of employee stock ownership plans, which encourage employees to invest in the stock of their employer and to increase their productivity. The reduction in the top income tax rate to 50 percent in 1982 also will encourage saving and direct saving away from tax shelter investments.

In addition, the Congress believed that additional incentives were needed to maintain and increase the viability of small businesses. Small businesses are important sources of employment, innovation, and competition, but are especially vulnerable during periods of high inflation, high interest rates, and economic stagnation. The Act, therefore, provides for significant reductions in estate and gift taxes, the expensing of relatively small amounts of investment, and other measures targeted to small businesses.

Many of the tax reductions in the Act are specifically targeted toward improving capital formation. The Congress believed that these tax cuts, in combination with individual income tax reductions, constitute a redirection of the Federal tax system that will restore the vitality of the national economy.

IV. GENERAL EXPLANATION OF THE ACT

TITLE I.—INDIVIDUAL INCOME TAX PROVISIONS

A. Individual Income Tax Reductions

1. Reductions in tax rates and alternative minimum tax (capital gains), repeal of maximum tax, and changes in withholding (secs. 101 and 102 of the Act and secs. 1, 21, 55, 541, 1348, 3402, and 6428 of the Code)*

Prior Law

Tax rates

Under the law prior to the Act, individual income tax rates began at 14 percent on taxable income in excess of $3,400 on joint returns and $2,300 on single returns, and ranged up to 70 percent on taxable income in excess of $215,400 for joint returns and $108,300 for single returns. The marginal tax rates which applied to married couples filing joint returns are shown in Table IV-5 below.

Prior law also imposed a 70-percent tax on the undistributed income of personal holding companies. In general, personal holding companies are closely held corporations the income of which consists largely of passive investment income.

Maximum tax

Under prior law, a maximum tax rate of 50 percent generally applied to personal service (earned) income.[1] Personal service income, for purposes of the maximum tax, included items such as wages, salaries, professional fees, and amounts received from pensions or annuities. The maximum tax applied to single individuals with taxable personal service income above $41,500 and married couples with taxable personal service income above $60,000, since prior law tax rates exceeded 50 percent at those levels.

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*For legislative background of the provisions, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 101, 102; S. Rep. No. 97-144 (July 6, 1981), pp. 22-28; Senate floor amendment, 127 Cong. Rec. S8730 (daily ed. July 29, 1981); H.R. 4242, as reported by the House Ways and Means Committee, secs. 101, 102; H. Rep. No. 97-201 (July 24, 1981), pp. 43-49; H.R. 4242, as passed by the House (July 29, 1981), secs. 101, 102; and H. Rep. No. 97-215 (August 1, 1981), p. 199 (Joint Explanatory Statement of the Committee of Conference).

[1] The actual marginal tax rate on earned income could have exceeded 50 percent, under prior law, even for those individuals whose tax liability was calculated using the maximum tax. This occurred because the tax liability on unearned income was calculated by "stacking" unearned after earned income, so that each additional dollar of earned income could push a taxpayer's unearned income into higher tax brackets. Moreover, because itemized deductions were, in effect, allocated on a pro rata basis between earned income and other income, each dollar of earned income caused an additional amount of itemized deductions to be allocated to earned income. Thus, an additional dollar of earned income caused a larger portion of itemized deductions to be deducted against income that would have been taxed at a 50-percent rate rather than at the higher rates applicable to other income.

Alternative minimum tax (capital gains)

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year. (Net capital gain is the excess of net long-term capital gain over net short-term capital loss.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's net capital gain under prior law was 28 percent (70-percent top tax rate on the 40-percent includible capital gain).

An alternative minimum tax (sec. 55) is imposed on noncorporate taxpayers in certain circumstances. This tax is payable by an individual to the extent that it exceeds the individual's regular income tax, including the "add-on" minimum tax (sec. 56). The alternative minimum tax is based on the sum of the taxpayer's gross income, reduced by allowed deductions, and increased by two tax preference items: (1) "excess" itemized deductions and (2) the capital gains deduction. The alternative minimum tax rate under prior law was ten percent for amounts from $20,000 to $60,000, 20 percent for amounts from $60,000 to $100,000, and 25 percent for amounts over $100,000.

Withholding

The withholding tax rates under prior law reflected the prior tax rates and zero bracket amount.

Individuals whose wages are subject to withholding may be entitled to a number of exemptions. Each exemption excludes $1,000 of annual wages from withholding and is claimed when filing a Form W-4. Exemptions allowed are: (1) one exemption for the taxpayer; (2) one additional exemption if the taxpayer has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) one exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming the exemptions on a separate Form W-4; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket allowance (which is equal to one exemption), unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding allowances for excess itemized deductions and tax credits; each such additional allowance exempts $1,000 of annual wages from withholding.

An individual who expects that income tax withheld will be less than final tax liability may reduce the number of withholding exemptions claimed or may enter into an agreement with the employer to increase the amount withheld. Individuals who have had no income tax liability for the preceding year and expect to have no tax liability for the current year may claim total exemption from withholding on wages.

Reasons for Change

Need for substantial tax cuts

The Act provides for reduction of individual income taxes by including one of the key recommendations of the President's economic recovery program—a three-year sequence of across-the-board reductions in marginal tax rates. When the last phase of reductions is reflected in withholding in July 1983, and in tax liability calculations for calendar year 1984, marginal rates and tax burdens will be approximately 23 percent less than they would have been under prior law.

The Congress believed that these marginal rate reductions accomplish two important goals of the economic recovery program. First, they provide equitable across-the-board relief from the excessive and steadily growing tax burden imposed under prior law. Second, they reduce the distortions, inefficiencies, and disincentives that result from the current high level of marginal tax rates.

Immediately prior to the Act, the average income tax burden, as a percentage of income, was higher than at any time during the last 20 years. A cornerstone of the economic recovery program is the reduction of the role the Federal government plays in the lives of American citizens. Other legislative action, such as the Omnibus Budget Reconciliation Act, provided substantial reductions in government spending programs; the Act returns to taxpayers the substantial resources that otherwise would have been absorbed by these programs.

Scope of tax reductions

The tax rate reductions are provided in an across-the-board manner under the Act in order to assure that all individuals share the relief in proportion to what their tax liability would have been had the shrinkage in the government's role not taken place. The 23-percent reduction is phased in, over three years, in a manner that will have a steady, predictable impact on the economy.

Table IV-1 below reflects the distribution of the tax cut under the Act by income class for 1982, 1983, and 1984.[2] Tables IV-2, IV-3, and IV-4 set forth comparative data on Federal income tax burdens on individuals at various income levels under the prior law and under the Act, showing the reduction in tax burden resulting from the Act, for 1982, 1983, and 1984, respectively.

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[2] The highest income group receives a 1984 tax reduction, as a percentage of prior law tax liability, which is lower than average because a large portion of the income received by this group—personal service income—was already subject to a maximum tax rate of 50 percent. The lowest income group receives a higher than average reduction because its tax liability has already been reduced substantially by the earned income credit; thus, a 23-percent reduction in tax liability before credits may lead to a substantially larger percentage reduction in tax liability after credits.

Table IV-1.—Distribution of Aggregate Revenue Loss Relative to Prior Law From Individual Income Tax Rate Reductions and Deduction for Two-Earner Married Couples in Effect in 1982, 1983, and 1984 [1]

[Millions of dollars; 1981 income levels]

Expanded income class [2]	Prior law tax liability [3]		1982 total reductions		1983 total reductions		1984 reductions						
							Rate reductions		Deduction for two-earner couples		Total		Total as percent of prior law liability
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	
Under $5,000	−157	(−0.1)	−69	(0.2)	−109	(0.2)	−114	(0.2)	0	(0.0)	−114	(0.2)	[4]
$5,000–$10,000	6,381	(2.2)	−937	(2.7)	−1,479	(2.5)	−1,718	(2.6)	−13	(0.2)	−1,731	(2.4)	27.1
$10,000–$15,000	16,317	(5.7)	−1,925	(5.6)	−3,287	(5.4)	−3,812	(5.8)	−88	(1.5)	−3,900	(5.4)	23.9
$15,000–$20,000	22,987	(8.0)	−2,651	(7.7)	−4,675	(7.7)	−5,407	(8.2)	−218	(3.7)	−5,625	(7.8)	24.5
$20,000–$30,000	58,558	(20.4)	−6,715	(19.4)	−12,349	(20.5)	−13,744	(20.8)	−1,149	(19.5)	−14,893	(20.7)	25.4
$30,000–$50,000	85,706	(29.9)	−10,183	(29.4)	−18,923	(31.4)	−19,695	(29.9)	−2,825	(48.0)	−22,520	(31.3)	26.3
$50,000–$100,000	51,631	(18.0)	−5,900	(17.1)	−11,002	(18.2)	−12,033	(18.2)	−1,222	(20.8)	−13,255	(18.4)	25.7
$100,000–$200,000	24,125	(8.4)	−2,639	(7.6)	−4,437	(7.4)	−5,116	(7.8)	−280	(4.8)	−5,396	(7.5)	22.4
Over $200,000	21,110	(7.4)	−3,583	(10.4)	−4,080	(6.8)	−4,328	(6.6)	−85	(1.4)	−4,413	(6.1)	20.9
Total	286,659	(100.0)	−34,603	(100.0)	−60,341	(100.0)	−65,966	(100.0)	−5,881	(100.0)	−71,847	(100.0)	25.1

[1] Percentage distribution of revenue loss in parentheses.
[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items, less investment interest to the extent of investment income.
[3] Net of outlay portion of the earned income credit.
[4] Not meaningful because this income class does not have positive tax liability.

Table IV-2.—Comparisons of Federal Individual Income Tax Burdens [1] Under Prior Law and Under the Act for Tax Year 1982

[Tax liability ($)]

Income [2]	Single person			One-earner married couple with no dependents			One-earner married couple with two dependents			Two-earner married couple with no dependents [3]			Two-earner married couple with two dependents [3]		
	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction
$5,000	250	216	34	0	0	0	−500	−500	0	0	0	0	−500	−500	0
$10,000	1,177	1,043	134	702	610	92	374	322	52	702	590	112	374	305	69
$15,000	2,047	1,836	211	1,625	1,434	191	1,233	1,082	151	1,625	1,398	227	1,233	1,052	181
$20,000	3,115	2,789	326	2,457	2,189	268	2,013	1,785	228	2,457	2,134	323	2,013	1,738	275
$30,000	5,718	5,152	566	4,477	4,012	465	3,917	3,512	405	4,477	3,918	559	3,917	3,418	499
$40,000	8,886	8,012	874	7,052	6,333	719	6,312	5,673	639	7,052	6,168	884	6,312	5,516	796
$50,000	12,559	11,320	1,239	10,183	9,156	1,027	9,323	8,376	947	10,183	8,912	1,271	9,323	8,132	1,191
$60,000	16,392	15,068	1,324	13,602	12,249	1,353	12,634	11,379	1,255	13,602	11,919	1,683	12,634	11,087	1,547
$100,000	31,792	30,468	1,324	28,878	26,721	2,157	27,878	25,741	2,137	28,878	26,109	2,769	27,878	25,129	2,749

[1] Includes the impact of the rate reductions and the deduction for two-earner married couples. Other individual income tax provisions not reflected here are indexing, the child care and dependent care credit, charitable contributions for nonitemizers, rollover period for sale of residence, and changes in the taxation of foreign earned income. Assumes that deductible expenses are 23 percent of income.

[2] Assumes that all income is wage and salary or self-employment income.

[3] Assumes lesser-earning spouse earns 25 percent of combined income.

Table IV-3.—Comparisons of Federal Individual Income Tax Burdens [1] Under Prior Law and Under the Act for Tax Year 1983

[Tax Liability ($)]

Income [2]	Single person			One-earner married couple with no dependents			One-earner married couple with two dependents			Two-earner married couple with no dependents [3]			Two-earner married couple with two dependents [3]		
	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction
$5,000	250	199	51	0	0	0	−500	−500	0	0	0	0	−500	−500	0
$10,000	1,177	951	226	702	564	138	374	296	78	702	527	175	374	264	110
$15,000	2,047	1,647	400	1,625	1,328	297	1,233	1,007	226	1,625	1,264	361	1,233	950	283
$20,000	3,115	2,505	610	2,457	1,998	459	2,013	1,642	371	2,457	1,903	554	2,013	1,557	456
$30,000	5,718	4,637	1,081	4,477	3,633	844	3,917	3,173	744	4,477	3,461	1,016	3,917	3,001	916
$40,000	8,886	7,233	1,653	7,052	5,724	1,328	6,312	5,124	1,188	7,052	5,424	1,628	6,312	4,852	1,460
$50,000	12,559	10,233	2,326	10,183	8,269	1,914	9,323	7,569	1,754	10,183	7,832	2,351	9,323	7,132	2,191
$60,000	16,392	13,613	2,779	13,602	11,054	2,548	12,634	10,264	2,370	13,602	10,454	3,148	12,634	9,739	2,895
$100,000	31,792	28,623	3,169	28,878	24,110	4,768	27,878	23,230	4,648	28,878	23,010	5,868	27,878	22,130	5,748

[1] Includes the impact of the rate reductions and the deduction for two-earner married couples. Other individual income tax provisions not reflected here are indexing, the child care and dependent care credit, charitable contributions for nonitemizers, rollover period for sale of residence, and changes in the taxation of foreign earned income. Assumes that deductible expenses are 23 percent of income.

[2] Assumes that all income is wage and salary or self-employment income.

[3] Assumes lesser-earning spouse earns 25 percent of combined income.

Table IV-4.—Comparisons of Federal Individual Income Tax Burdens [1] Under Prior Law and Under the Act for Tax Year 1984

[Tax Liability ($)]

Income [2]	Single person			One-earner married couple with no dependents			One-earner married couple with two dependents			Two-earner married couple with no dependents [3]			Two-earner married couple with two dependents [3]		
	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction	Under prior law	Under the Act	Reduction
$5,000	250	193	57	0	0	0	−500	−500	0	0	0	0	−500	−500	0
$10,000	1,177	915	262	702	539	163	374	291	83	702	504	198	374	261	113
$15,000	2,047	1,572	475	1,625	1,253	372	1,233	952	281	1,625	1,193	432	1,233	900	333
$20,000	3,115	2,392	723	2,457	1,885	572	2,013	1,549	464	2,457	1,795	662	2,013	1,469	544
$30,000	5,718	4,385	1,333	4,477	3,443	1,034	3,917	3,003	914	4,477	3,278	1,199	3,917	2,838	1,079
$40,000	8,886	6,827	2,059	7,052	5,434	1,618	6,312	4,874	1,438	7,052	5,154	1,898	6,312	4,615	1,697
$50,000	12,559	9,673	2,886	10,183	7,825	2,358	9,323	7,165	2,158	10,183	7,413	2,770	9,323	6,753	2,570
$60,000	16,392	12,839	3,553	13,602	10,456	3,146	12,634	9,706	2,928	13,602	9,886	3,716	12,634	9,211	3,423
$100,000	31,792	27,155	4,637	28,878	22,896	5,982	27,878	22,056	5,822	28,878	21,846	7,032	27,878	21,006	6,872

[1] Includes the impact of the rate reductions and the deduction for two-earner married couples. Other individual income tax provisions not reflected here are indexing, the child care and dependent care credit, charitable contributions for nonitemizers, rollover period for sale of residence, and changes in the taxation of foreign earned income. Assumes that deductible expenses are 23 percent of income.

[2] Assumes that all income is wage and salary or self-employment income.

[3] Assumes lesser-earning spouse earns 25 percent of combined income.

Impact on economic recovery

The Congress believed that the 23-percent reduction in marginal rates itself will play a crucial role in the economic recovery. An individual's marginal tax rate is the rate applicable to the last dollar of income received or to the next dollar of income to be received. For an individual with a 30-percent marginal rate, for example, the return from additional work effort and saving is reduced by 30 percent. Thus, the marginal tax rate substantially affects the return from additional work effort and additional saving. Because average marginal tax rates were at their highest point in recent history, they were an important cause of the economic distortion and inefficiency induced by the individual income tax. The Act reduces this tax-induced distortion.

With respect to work effort, the Congress believed that the reduction in marginal rates, and the resulting increase in the reward for additional work effort, will lead to increased willingness to work full-time rather than part-time, greater acceptance of overtime assignments, less absenteeism, and more individuals in the labor force. Further, lower marginal rates are expected to reduce the proportion of compensation which, partly or wholly for tax reasons, employees now demand in the form of tax-free fringe benefits, and should improve voluntary compliance with the income tax.

The Congress also believed that the increase, resulting from marginal rate reductions, in the after-tax return to saving will significantly increase personal saving, thus insuring adequate financing for the additional investment encouraged by other provisions of the Act. The urgency with which the Congress viewed this need is reflected in its decision to reduce the highest marginal rate by 20 percentage points on January 1, 1982, rather than to phase in this change as is the case with other rate reductions. Because prior law already provided a special maximum tax rate on earned income, this change was intended to eliminate a substantial disincentive to investment.

In addition to providing a stimulus for additional saving, the marginal rate reductions will encourage the expansion of many small business activities by increasing the after-tax return to those activities. Moreover, by increasing the after-tax cost of borrowing, marginal rate reductions will reduce the incentive for borrowing (or dissaving) that results from the deduction for interest. Further, individuals will be less inclined to shift their investments from highly taxed, productive activities, to lightly taxed, less productive investments such as tax shelters and precious metals. Finally, lower marginal rates will reduce the "lock-in" effect of the prior treatment of capital gains, thus increasing the likelihood that capital assets will be employed in their most efficient uses.

Explanation of Provisions

a. Reduction in tax rates

In general

The Act reduces individual income tax rates in each tax bracket. By 1984, all tax rates in current tax rate schedules will be reduced by approximately 23 percent. Moreover, the highest marginal tax

rate is reduced from 70 percent to 50 percent as of January 1, 1982; this 50-percent maximum rate is applied in all years to the rate schedules that would have resulted from the across-the-board reductions by themselves. Thus, when the tax rate cuts are phased in fully, tax rates will range from 11 percent to 50 percent instead of the prior law range of 14 percent to 70 percent.

The Act reduces individual income tax liability in four stages:

● For tax years beginning in 1981, there is a tax credit against regular tax equal to 1¼ percent of regular tax liability before other credits. For this purpose, regular tax means all taxes imposed by section 1, or by other sections in lieu of the tax imposed by section 1. Regular tax also includes taxes such as the special ten-year averaging method for lump-sum distributions from a qualified retirement plan that are computed by means of the tax rate schedules in section 1. However, the Congress did not intend the credit to apply against the part of the maximum tax on personal service income that is computed at 50 percent, or the part of the alternative tax on capital gains (see c., below) that is computed at 20 percent. This credit corresponds to a five-percent reduction in withholding, effective October 1, 1981. The Treasury Department is required to incorporate this credit in the Code section 3 tax tables for 1981 and has the authority to modify the applicable rate schedules of section 1 to reflect the credit or to prescribe other tables that reflect the amount of credit for different levels of tax or taxable income.

● For tax years beginning in 1982, there are across-the-board rate reductions averaging about ten percent below prior law.

● For tax years beginning in 1983, there are additional across-the-board rate reductions of ten percent, resulting in rates about 19 percent below prior law. (The two ten-percent rate reductions lead to a 19-percent, rather than a 20-percent, reduction because the second ten-percent reduction is applied to the rates in effect after the first ten-percent reduction.)

● Finally, for tax years beginning in 1984, the permanent rate schedules, incorporating further reductions of five percent and total across-the-board reductions of about 23 percent below prior law, take effect. (The additional five-percent rate cut leads to a 23-percent, rather than a 25-percent, cut in the rates in effect prior to the Act because the five-percent reduction is applied to the rates in effect after the two previous ten-percent reductions.)

To conform the tax on undistributed personal holding company income to the reduction in the maximum individual income tax rate from 70 percent to 50 percent, the Act reduces the tax rate on that income to 50 percent.

The marginal tax rates under the Act for married couples filing joint returns are shown in Table IV–5, below. The new rate schedules for 1982, 1983, and 1984 and thereafter are set forth in the Appendix.

Table IV-5.—Tax Rate Schedules Under Prior Law and the Act for 1982, 1983, and 1984 (Joint Returns)

[In percent]

Taxable income bracket	Under prior law	Under the Act		
		1982	1983	1984
0 to $3,400	0	0	0	0
$3,400 to $5,500	14	12	11	11
$5,500 to $7,600	16	14	13	12
$7,600 to $11,900	18	16	15	14
$11,900 to $16,000	21	19	17	16
$16,000 to $20,200	24	22	19	18
$20,200 to $24,600	28	25	23	22
$24,600 to $29,900	32	29	26	25
$29,900 to $35,200	37	33	30	28
$35,200 to $45,800	43	39	35	33
$45,800 to $60,000	49	44	40	38
$60,000 to $85,600	54	49	44	42
$85,600 to $109,400	59	50	48	45
$109,400 to $162,400	64	50	50	49
$162,400 to $215,400	68	50	50	50
$215,400 and over	70	50	50	50

Fiscal-year taxpayers

Because the Act provides for new rate schedules each year (specified schedules for 1982, 1983, and 1984, and adjustments for inflation in 1985 and after, as described below), the Act provides that fiscal-year taxpayers are not to compute their tax liability by prorating taxable income between two rate schedules. Instead, these taxpayers will use only one rate schedule, which will be determined according to the date on which the fiscal year begins.

Thus, for taxable years beginning in 1981, it is intended that fiscal-year taxpayers will use the prior law rate schedules to compute tax liability and will not prorate with the 1982 schedules provided in the Act. (The rate reduction credit, of course, will apply to tax liability for taxable years beginning in 1981.) For taxable years beginning in 1982, fiscal-year taxpayers will use only the 1982 rate schedules and will not prorate with 1983 schedules, and so forth. The Internal Revenue Service, therefore, will be spared the complications which would have been involved if prorating were allowed for all future years.

b. Reduction in alternative minimum tax (capital gains)

As a result of reducing the maximum regular tax rate from 70 percent to 50 percent, the Act reduces the maximum rate of tax on net capital gains from 28 percent to 20 percent, even though the deduction for 60 percent of net capital gains is not increased. This 20-percent capital gain rate results from applying the highest tax rate under the Act (50 percent) to the 40 percent of net capital gain

that is includible in gross income. (The 28-percent corporate capital gains rate is not reduced by the Act.)

In order to conform the alternative minimum tax to the reduction in the maximum regular tax on net capital gains, the Act reduces the top alternative minimum tax rate from 25 percent to 20 percent. Thus, under the Act, the alternative minimum tax rate is ten percent for amounts from $20,000 to $60,000 and 20 percent for amounts in excess of $60,000.

c. Special rules for net capital gains after June 9, 1981

Because the Congress did not want individuals to postpone the disposition of capital assets until 1982 in order to take advantage of the effect that the 50-percent maximum tax rate has on the taxation of net capital gains, the Act provides a special alternative tax so that a maximum 20-percent rate on net capital gains applies to sales or exchanges occurring after June 9, 1981.

Specifically, a taxpayer other than a corporation who has net capital gains for any taxable year ending after June 9, 1981, and beginning before January 1, 1982 will pay a tax equal to the lesser of: (1) the sum of the regular tax on all taxable income other than 40 percent of the qualified net capital gain, plus a tax at the rate of 20 percent on the qualified net capital gain, or (2) the regular tax on all taxable income (including 40 percent of qualified net capital gain). Qualified net capital gain is the lesser of the net capital gain for the taxable year or the net capital gain for the taxable year taking into account only gain or loss from sales or exchanges occurring after June 9, 1981. Thus, qualified net capital gain does not take into account taxable receipts after June 9, 1981, of proceeds from any sale or exchange that occurred prior to that date. (For taxable years beginning after 1981, however, such proceeds will be taxable at the reduced rates which result from the changes in the rate schedules.) Further, this provision does not apply to taxpayers who have an excess of capital losses over capital gains for the taxable year taking into account either gain or loss only from sales or exchanges occurring after June 9, 1981 or all gain or loss.

Likewise, with respect to the alternative minimum tax, an individual's tax is limited to the sum of the alternative minimum tax on alternative minimum taxable income other than qualified net capital gain, plus a 20-percent tax on qualified net capital gain. Credits other than the foreign tax credit are not allowed against the qualified net capital gain portion of the alternative minimum tax.

In applying this provision with respect to any pass-through entity, the determination of when a sale or exchange has occurred is to be made at the entity level. A pass-through entity is a regulated investment company, real estate investment trust, electing small business corporation, partnership, estate, trust, or common trust fund.

d. Elimination of maximum tax

Under the Act, the highest marginal tax rate on all types of income is reduced to 50 percent, for taxable years beginning after December 31, 1981. Therefore, the maximum tax rate on personal

service income, which would have become redundant, is repealed by the Act for taxable years beginning after this date.

e. Withholding changes

In general

Under the Act, three changes in income tax withholding rates are scheduled. An initial reduction in income tax withholding takes effect on October 1, 1981, as if a five-percent reduction in tax rates occurred. There is a further reduction on July 1, 1982, as if a ten-percent reduction in tax rates occurred on that date, amounting to a cumulative reduction of 14½ percent. (The cumulative reduction is less than 15 percent because the ten-percent reduction applies to the withholding rates in effect after the initial five-percent reduction.) There is a final reduction on July 1, 1983, as if another ten-percent reduction in tax rates occurred on that date, for a total cumulative reduction of 23 percent.

In addition to the withholding changes made to reflect the tax rate reductions, the Act makes several changes in the withholding system. These changes have two objectives. One is to make the withholding requirements flexible enough to permit taxpayers to adjust their withholding in order to match tax liability as closely as possible and, thus, to reduce the possibility of overwithholding. The other objective is to assure that taxpayers do not claim excessive numbers of withholding exemptions or allowances and, thus, to assure that underwithholding does not occur. (Also, see the changes in applicable penalties made by section 721 of the Act.) Both objectives are accomplished primarily by giving the Treasury Department authority to issue regulations to accomplish these goals.

Additional allowances or reductions

The Act provides that withholding is to be determined in accordance with tables or computational procedures prescribed by the Treasury and that the maximum number of withholding exemptions to be claimed by an individual is to be determined pursuant to Treasury regulations. In determining the number of additional withholding allowances (or additional reductions), an employee will be permitted to take into account, to the extent and in the manner provided in the regulations, estimated itemized deductions, estimated tax credits, and such additional deductions and other items that may be specified by the regulations.

The Congress expects the Treasury to issue promptly these regulations and any forms, tables, and computational procedures which may be needed. It is expected that these regulations will provide flexibility for additional withholding allowances in situations where taxpayers anticipate business losses and non-business deductions during the year, unless taking these items into account would distort the amount of tax withheld in relation to the amount of tax owed.

The deletion of the detailed rules of prior law on computing additional withholding allowances is not intended to prevent the Treasury (Internal Revenue Service) from using tests similar to those under prior law to determine the accuracy and reasonableness of withholding exemptions or allowances claimed by a taxpayer insofar as such use is consistent with the objectives of the Act.

For example, the Treasury is not required by these changes to discontinue review of returns for previous years or examination of the taxpayer's expectations for the year in question to determine the reasonableness of claims on withholding allowance certificates.

Increased flexibility

The Act makes several other changes which increase the flexibility of the withholding system. The Treasury is allowed to prescribe that more than one additional withholding exemption may be allowed to taxpayers who may claim a zero bracket (special withholding) allowance because they are neither married to a wage-earning spouse nor working for more than one employer (prior law allowed only one additional exemption for such taxpayers). Moreover, the Treasury is authorized to provide by regulations that employees may have withholding either increased or reduced at their request (prior law provided only for increases) and that an employee may achieve such increased or reduced withholding without the employer's consent. (Prior law required both the employer and employee to agree to increased withholding.)

Effective Date

The 1981 rate reduction credit is effective for taxable years beginning in 1981. The general rate reductions, repeal of the maximum tax on personal service income, reduction of the alternative minimum tax, and reduction of the personal holding company tax are effective for taxable years beginning after December 31, 1981. The elimination of proration for fiscal year taxpayers is intended to be effective for taxable years beginning after January 1, 1981. Two additional rate reductions are effective for taxable years beginning after December 31, 1982, and 1983, respectively. The withholding provisions are applicable to remuneration paid after September 30, 1981, except that the amendment allowing new procedures for computing additional withholding allowances applies to remuneration paid after December 31, 1981.

The reduction in the maximum tax rate for net capital gains (including the related limitation on the alternative minimum tax) is effective for sales or exchanges occurring after June 9, 1981, for any taxable year ending after June 9, 1981, and beginning before January 1, 1982.

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by $39 million in 1981, $26,148 million in 1982, $65,703 million in 1983, $104,512 million in 1984, $122,652 million in 1985, and $143,832 million in 1986. These figures include the increase in outlays attributable to the earned income credit; this increase occurs because of the reduction in tax rates. (To the extent that the earned income credit exceeds tax liability, it is treated as an outlay under budget procedures.)

2. Deduction for two-earner married couples (sec. 103 of the Act and secs. 62, 85, 105, and new sec. 221 of the Code)*

Prior Law

Under present and prior law, a married couple generally is treated as one tax unit which must pay tax on the unit's total taxable income. Although couples may elect to file separate returns, the law is structured so that filing separate returns almost always results in a higher tax than filing joint returns. In addition, different tax rate schedules apply to single persons and to single heads of households.

Along with other provisions of the tax law, these rate schedules gave rise to a "marriage penalty" when persons with relatively equal incomes married each other and a "marriage bonus" when persons with relatively unequal incomes married each other. In general, if two persons' combined income was allocated between them more evenly than 80%-20%, their combined income tax liability increased when they married.

Reasons for Change

The Congress was concerned about the marriage tax penalty and decided that a suitable response to this problem was to allow married couples a new deduction equal to a percentage of the earnings of the spouse with lower earnings.

Any attempt to alleviate the marriage penalty involves the reconciliation of several competing objectives of tax policy. For many years, one accepted goal has been the equal taxation of married couples with equal incomes. This has been viewed as appropriate because married couples frequently pool their income and consume as a unit, and thus it has been thought that married couples should pay the same amount of tax regardless of how the income is divided between spouses. This result generally was achieved under prior law.

The Congress believed that alleviation of the marriage penalty was necessary because large tax penalties on marriage undermined respect for the family by affected individuals and for the tax system itself. To do this, the Congress was obliged to make a distinction between one-earner and two-earner married couples. The simplest way to alleviate the marriage penalty was to allow a percentage of the earned income of the spouse with the lower earnings to be, in effect, free from income tax.

This provision also alleviates another effect of the prior system on all married couples—high effective marginal tax rates on the second earner's income. Recent studies have shown that these high

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 103; S. Rep. No. 97-144 (July 6, 1981), pp. 29-33; H.R. 4242, as reported by the House Ways and Means Committee, sec. 122; H. Rep. No. 97-201 (July 24, 1981), pp. 52-55; H.R. 4242, as passed by the House (July 29, 1981), sec. 103; and H. Rep. No. 97-215 (August 1, 1981), p. 200 (Joint Explanatory Statement of the Committee of Conference).

marginal rates had a significant adverse effect on second earners' decisions to seek paying jobs. The ten-percent reduction in marginal tax rates for second earners provided by the new deduction will reduce this work disincentive. In addition, some contend that two-earner couples are less able to pay income tax than one-earner couples with the same amount of income because the former have more expenses resulting from earning income, as well as less free time. Under this concept, the new deduction will improve equity by reducing the tax burdens of two-earner couples compared to one-earner couples.

The second-earner deduction reduces the marriage penalty and improves work incentives for second earners without abandoning the basic principle of encouraging joint returns. Allowing married couples to file separate returns as single taxpayers would have been very complex because of the necessity for rules to allocate income and deductions between the spouses. If separate filing were optional, many couples would have been burdened by having to compute tax liability under both options (separately and jointly) in order to determine which method minimized their liability. Further, separate filing would have provided tax reductions with respect to all types of income received by married couples, while the Congress believed that relief was essential for wages and salaries received by second earners. Also, separate filing would have reduced taxes only for couples affected by the marriage penalty, but the Congress believed that there should be a tax reduction for all two-earner married couples.

The substantial reductions in the marriage penalty resulting from both this new deduction and the overall reductions in marginal rates provided by the Act are shown in Table IV-6, below. This new deduction is a major step towards the goal of eliminating the marriage penalty completely.

Table IV-6.—Marriage Tax Penalty for Two-Earner Couples Under Prior Law and the Act for 1984

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Prior law	$103	$185	$157	−$134	−$241
Act	−121	−84	−146	−512	−2,360
$20,000					
Prior law	185	822	1,350	1,701	1,671
Act	−84	90	388	557	−837
$30,000					
Prior law	157	1,350	2,166	2,901	2,918
Act	−146	388	606	1,110	185
$50,000					
Prior law	−134	1,701	2,901	3,760	3,777
Act	−512	557	1,110	2,290	2,007
$100,000					
Prior law	−241	1,671	2,918	3,777	3,794
Act	−2,360	−837	185	2,007	3,390

NOTES:
The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, and that deductible expenses are 23 percent of adjusted gross income and are allocated between spouses in proportion to income.
Computations under the Act assume the rate schedules and two-earner couple deduction in effect in 1984.

Explanation of Provision

General rules

With certain exceptions, two-earner married couples who file joint returns are allowed a new deduction from gross income in arriving at adjusted gross income (new sec. 221). Taxpayers may claim this deduction even if they do not itemize personal deductions.

The deduction will equal ten percent (five percent for taxable years beginning in 1982) of the lesser of the qualified earned income of the spouse with the lower qualified earned income or $30,000. Thus, the maximum deduction will be $1,500 for taxable years beginning in 1982 and $3,000 for subsequent taxable years. If the qualified earned income of each spouse for the taxable year is the same, the Congress intended that the deduction may be computed using the qualified earned income of either one of the spouses.

Qualified earned income

In general, qualified earned income is earned income within the meaning of section 401(c)(2)(C) or section 911(d)(2) (as redesignated by the Act), less specified deductions allowable under section 62 that are properly allocable to or chargeable against such earned income in determining qualified earned income. However, qualified earned income is determined without regard to the 30-percent limitation in section 911(d)(2) on compensation from a trade or business in which both personal services and capital are material income-producing factors. Qualified earned income is not intended to include unemployment compensation paid under a government program.

Under the Act, qualified earned income does not include any amount that is not includible in gross income.[1] In addition, the qualified earned income of each spouse is computed without regard to any community property laws; that is, earned income is attributed to the spouse who renders the services for which the earned income is received.

Pensions, annuities, individual retirement plan distributions, and deferred compensation are excluded from qualified earned income. For this purpose, deferred compensation generally is any amount received after the close of the taxable year following the taxable year in which the services to which the amount is attributable are performed.[2] Also, wages exempt from certain social security taxes because an individual is in the employ of his or her spouse are excluded from qualified earned income.[3]

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[1] Amounts which are excluded from gross income are not counted as qualified earned income because untaxed income does not give rise to a work disincentive or a marriage penalty.

[2] Pensions and annuities are excluded because these amounts are composed largely of investment income (e.g., interest on plan contributions) that has accumulated tax-free; this exclusion is also necessary to focus the benefits of the deduction on individuals currently earning income and to avoid a windfall for those whose work took place in past years. The exclusion of pensions and annuities is consistent with the definitions applicable to the earned income credit. Distributions from individual retirement plans have been excluded to maintain parity with qualified plans. Other forms of deferred compensation are excluded from qualified earned income for similar reasons.

[3] These amounts are excluded because the existing exemption of these wages from social security tax already provides substantial relief to these second earners and because, otherwise, there could be opportunities to shift earned income between spouses and attribute an inaccurate

Deductible items

Certain items deductible under section 62 must be deducted in computing qualified earned income. These items are: (1) deductions attributable to a trade or business from which earned income is derived, except that if some of the gross income from a trade or business does not constitute earned income, only a proportional share of the deductions attributable to such trade or business must be deducted (section 62(1)); (2) deductions consisting of certain expenses paid or incurred in connection with the performance of services as an employee (section 62(2)); (3) deductions for contributions by a self-employed person to a qualified retirement plan (section 62(7)); (4) certain deductions relating to pension plans of subchapter S corporations (section 62(9)); (5) deductions for contributions to an individual retirement plan (section 62(10)); and (6) deductions for certain required repayments of supplemental unemployment compensation benefits (section 62(15)).

Other rules

The Act includes conforming amendments specifying that the amounts of unemployment compensation and disability income included in adjusted gross income are to be computed without regard to this deduction. Then, the deduction is to be computed excluding from qualified earned income amounts of disability (or other) income not included in gross income.

The Act also provides that no deduction is allowable if either spouse claims, on the couple's joint return for the taxable year, the benefits of section 911 (relating to citizens or residents of the United States living abroad) or section 931 (relating to income from sources within possessions of the United States).[4]

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $419 million in 1982, $4,418 million in 1983, $9,090 million in 1984, $10,973 million in 1985, and $12,624 million in 1986.

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or unreasonable amount of earned income to the second earner. If the employer is a corporation owned by the spouse rather than an unincorporated spouse, wages paid to the employee are not exempt from social security taxes and are therefore included in qualified earned income.

[4] Couples benefiting from these provisions are excluded from the new deduction because of the substantial relief provided elsewhere in the Act for income earned abroad and the complexity of coordinating the new deduction with these provisions. This is consistent with the eligibility rules for the earned income credit.

3. Indexing of rate brackets, zero bracket amount, and personal exemption in 1985 and later years (sec. 104 of the Act and secs. 1, 63, 151, 6012, and 6013 of the Code)*

Prior Law

In general, income tax liability has been based on various fixed dollar amounts, such as the amount of the personal exemption, the zero bracket amount, and the minimum and maximum levels of the marginal tax rate brackets. These amounts have remained fixed until changed by legislation. The zero bracket amount and the amount of the personal exemption also enter into the determination of whether an individual must file a return.

Very few provisions of the Code have been varied (indexed) according to the rate of inflation. The limits on contributions to and benefits from qualified pension plans are indexed for inflation as measured by the consumer price index. The windfall profit tax is indexed for inflation as measured by the implicit price deflator for the gross national product.

Reasons for Change

Inflation erodes the value of the fixed dollar amounts utilized to determine tax liability. As a result, when incomes rise by (say) ten percent, income taxes rise by approximately 16 percent. This is an increase in the real tax burden of approximately six percent and occurs even though the increase in real incomes may be much less than ten percent (or even zero).

The Congress believed that "automatic" tax increases resulting from the effects of inflation were unfair to taxpayers, since their tax burden as a percentage of income could increase during intervals between tax reduction legislation, with an adverse effect on incentives to work and invest. In addition, the Federal Government was provided with an automatic increase in its aggregate revenue, which in turn created pressure for further spending.

The across-the-board marginal rate reductions provided by the Act are intended to decrease significantly income tax liability as a percentage of a taxpayer's income by 1984. Thereafter, indexing will prevent inflation from increasing that percentage and thus will avoid the past pattern of inequitable, unlegislated tax increases and induced spending.

Explanation of Provision

In general

The minimum and maximum dollar amounts for the marginal rate brackets (including the zero bracket) and the dollar amount of

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7777 (daily ed. July 16, 1981); H.R. 4242, as passed by the House (July 29, 1981), sec. 104; and H. Rep. No. 97-215 (August 1, 1981), p. 200 (Joint Explanatory Statement of the Committee of Conference).

the personal exemption which apply in 1984 will be adjusted each year, commencing with amounts applicable to taxable years beginning after December 31, 1984.

The amount of the adjustment to provisions applicable to taxable years beginning in a given calendar year will depend on the percentage by which the average of the levels of the Consumer Price Index (CPI) for all urban consumers for the 12 months ending with September of the preceding calendar year (i.e., for the 12 months comprising the preceding fiscal year) exceeds the average of the levels of the CPI for the 12 months from October 1982 through September 1983, inclusive (i.e., fiscal year 1983). For example, in late 1984, the Treasury will compute the average of CPI levels for the months of October 1983 through September 1984, inclusive (i.e., fiscal year 1984). The percentage by which this average exceeds the similar average of the levels for the 12 months of fiscal year 1983 will be the cost-of-living adjustment used in deriving the rate schedules and personal exemption amount applicable to taxable years beginning in 1985. A new computation will be made each calendar year, always using the percentage increase in the CPI between the preceding fiscal year and the base period of fiscal year 1983.

It is possible for these adjustments to provide tax increases in future years if price levels fall. For example, assume that the CPI in fiscal year 1989 is considerably higher than in fiscal year 1983 but that the CPI declines between fiscal year 1989 and fiscal year 1990. The Act provides that there would be a reduction of the personal exemption and the taxable income brackets in 1990. However, this reduction would not reduce the tax brackets and the exemption below the amounts prevailing in 1984, even if the CPI declined to a level below its level for fiscal year 1983.

Adjustment of rate schedules

The rate schedules for any taxable year beginning in 1985 or succeeding years will be derived by adjusting the taxable income amounts in the rate schedules provided, in section 101 of the Act, for taxable years beginning after 1983. A new adjustment of these rate schedules will be made each year. For example, the rate schedules for taxable years beginning in 1985 will be computed by increasing these taxable income amounts by the cost-of-living adjustment percentage calculated according to the example and rounding the resulting amounts to the nearest $10.

Tax rates applicable in each bracket will not change, but the amounts of tax liability shown in the rate schedules will be changed to conform to the adjustment in taxable income amounts. A conforming amendment provides that the zero bracket amount (the amount which is subtracted from total itemized deductions to determine the amount which itemizers may actually deduct from adjusted gross income) always will be equal to the amount of taxable income on which no tax is imposed under the applicable rate schedule.

Adjustment of personal exemption

Similar annual adjustments will be made to the $1,000 personal exemption amount. Increasing the $1,000 figure by the applicable

cost-of-living adjustment and rounding it to the nearest $10 will provide the exemption amount applicable to taxable years beginning in 1985 and each succeeding year. The exemption amount applicable to taxable years beginning in any given calendar year will be derived by using the same cost-of-living adjustment used to derive the rate schedules applicable to these same taxable years.

Conforming amendments provide that income levels above which taxpayers must file tax returns will increase in order to maintain the same relationship with the zero bracket and exemption amounts as under prior law.

Effective Date

This provision is applicable to taxable years beginning after December 31, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $12,941 million in 1985 and $35,848 million in 1986.

B. Foreign Earned Income Exclusion
(Secs. 111-115 of the Act and secs. 37, 43, 63, 105, 119, 410, 879, 911, 913, 1302, 1303, 1304, 1402, 3401, 6012, and 6091 of the Code)*

Prior Law

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents generally are taxed by the United States on their worldwide income, with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens or residents working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 510 days (approximately 17 months) out of a period of 18 consecutive months or, in the case of citizens, if they were *bona fide* residents of a foreign country for a period which included an entire taxable year (sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 generally would have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. In addition, the 1976 Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion, for years beginning after December 31, 1977, with a new deduction for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaced the section 911 foreign earned income exclusion for years beginning after December 31, 1977 with a new deduction for the excess costs of working overseas. The basic eligibility requirements for the deduction generally were the same as for the prior earned income exclusion.

The excess living cost deduction (sec. 913) consisted of separate elements for the general cost of living, housing, education, and

*For legislative background of the provisions, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 111-115; S. Rep. No. 97-144 (July 6, 1981) pp. 34-38; H.R. 4242, as reported by the House Ways and Means Committee, secs. 141-145; H. Rep. No. 97-201 (July 24, 1981), pp. 58-63; H.R. 4242, as passed by the House (July 29, 1981), secs. 111-115; and H. Rep. No. 97-215 (August 1, 1981), pp. 203-205 (Joint Explanatory Statement of the Committee of Conference).

home leave costs. The cost-of-living element of the deduction was generally the amount by which the cost of living in the taxpayer's foreign tax home exceeded the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction was based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14, step 1, regardless of the taxpayer's actual income. The housing element was the excess of the taxpayer's reasonable housing expenses over the base housing amount (generally one-sixth of his net earned income). The education deduction was generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consisted of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas were allowed a special $5,000 per year deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas were generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees was 15 percent or more of their base pay.

As an exception to these rules, prior law permitted employees who resided in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the excess living cost and hardship area deductions. No foreign tax credit was allowed for foreign taxes attributable to the excluded amount, and deductions attributable to the excludable amount were not allowed. For taxpayers electing the exclusion, the camp was treated as the employer's business premises so that the exclusion for employer-provided meals and lodging also could be claimed (provided the other requirements of sec. 119 are satisfied).

The 1978 Act liberalized the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extended the regular 18-month or 24-month period for reinvestment of proceeds realized on the sale of a principal residence to up to four years in the case of Americans working abroad.

Under certain circumstances, the time limits of the eligibility requirements for the excess living cost deduction or the exclusion could be waived. Three conditions had to be met for the waiver to apply. First, the individual actually must have been present in, or a *bona fide* resident of, a foreign country. Second, the individual must have left the foreign country after August 31, 1978, during a period with respect to which the Treasury Department determines, after consultation with the State Department, that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. Third, the individual must have established to the satisfaction of the Treasury that he reasonably could have been expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions. If these criteria are met, the taxpayer is

treated as having met the foreign residence or presence requirements with respect to the period while resident or present in the foreign country even though the relevant time limitation under existing law has not been met.

Reasons for Change

The Congress was concerned with the increasing competitive pressures that American businesses faced abroad. The Congress decided that in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive.

The Congress believed that the tax burdens imposed on these individuals made it more expensive for U.S. businesses to utilize American employees abroad. In many cases, the policy of these businesses is to reimburse their employees for any extra tax expenses the employees incur because of overseas transfers. Thus, an extra tax cost to the employees becomes a cost to the business, which cost often is passed through to customers in the form of higher prices. In intensely competitive industries, such as construction, this can lead to noncompetitive bids for work by American firms.

As a result, some U.S. companies either cut back their foreign operations or replaced American citizens in key executive positions with foreign nationals. In many cases, these foreign nationals may purchase goods and services for their companies from their home countries, rather than from the United States, because they often are more familiar with those goods and services.

The Congress was also concerned with the complexity of prior law. Because the deductions that U.S. persons working abroad could take varied significantly from case to case, it was often difficult for an American to estimate what his tax liability would be if he planned to work overseas. In addition, many Americans employed abroad found it necessary to use costly professionals to complete their tax returns.

Accordingly, the Congress changed the tax law to encourage Americans to work abroad, in order to help promote the export of U.S. manufactured goods and services. It was decided that reducing the tax burden on Americans working abroad will make American enterprises more competitive in foreign markets. The Congress determined that a broad range of activities by Americans abroad serves to benefit the U.S. economy and should be encouraged.

The Congress concluded that an appropriate incentive, to replace the excess foreign living cost deduction and exclusion, was to allow qualifying Americans to elect a substantial exclusion from U.S. tax for their foreign earned income. At the same time, the Congress placed a specific dollar limitation on the exclusion. This limitation is intended to prevent abuse of the exclusion, for example, by highly paid entertainers or athletes who might otherwise move abroad to avoid U.S. tax on their income. In addition, the Congress provided an exclusion or deduction from income measured by excess foreign housing costs.

The Congress also concluded that the prior treatment of foreign earned income should be liberalized by shortening the period of foreign presence required to qualify for the exclusions, and that the

residence or presence period should continue to be waived in certain circumstances where civil unrest prevents individuals from meeting those requirements.

Explanation of Provisions

In general

The Act replaces the prior deductions for excess living costs with an exclusion from tax of an individual's foreign earned income up to a statutory limit. It also modifies the eligibility standards for the exclusion.

In order to qualify for the exclusion, an individual must first meet either a residence test or a presence test. No change is made in the *bona fide* residence test; that is, an individual meets the residence test if he is a *bona fide* resident of one or more foreign countries for an uninterrupted period which includes an entire taxable year. The Act provides that an individual also is eligible for the special provisions if present in a foreign country or countries for 330 full days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under prior law).

Also, in order to be eligible for the exclusion, the individual must have his tax home (within the meaning of the provisions of the Code dealing with away from home expenses) in a foreign country. An individual is not considered as having a home in a foreign country for a year in which his abode is in the United States.

Individuals meeting these requirements generally may elect to exclude up to $75,000 of foreign earned income attributable to the period of foreign residence or presence, for taxable years beginning on or after January 1, 1982. This exclusion is increased by $5,000 a year over the next four years to $95,000. Thus, at the end of the phase-in period in 1986 and after, a taxpayer will be able to exclude up to $95,000 per year. In the case of a married couple, the exclusion is computed separately for each qualifying individual.

For purposes of computing the maximum amount excludable for any year, amounts received are taken into account in the taxable year in which the services to which the amounts are attributable are performed. Thus, for example, if an individual performs services in 1982 and receives a delayed payment in 1983, the payment received in 1983 will be counted against the 1982 $75,000 limitation. That payment will be excludable in 1983, subject to the limitation and qualification in 1982.

The definition of earned income is identical to that in prior law. Thus, the income must be earned from sources within a foreign country or countries. It does not, however, need to be remitted to a foreign country. For example, if an individual performs services in Saudi Arabia, and has her salary remitted to a bank in New York, the salary amounts qualify as foreign earned income provided all of the other relevant tests are met. As under prior law, pensions, annuities, and income from certain trusts are not foreign earned income and thus are not excludable.

If income is community income of a husband or wife, the total amount that may be excludable by the husband and wife for the

taxable year is the amount that would have been excludable if the income was not community income.

Effect of election

A taxpayer may exclude foreign earned income from tax only if he elects to do so. Once an election to exclude foreign earned income for a taxable year is made, the election remains in effect for that year and all future years. The election may be revoked with the consent of the Internal Revenue Service. In addition, the election may be revoked by the taxpayer without consent. However, if the election is revoked without consent, the taxpayer cannot again make another election until the sixth taxable year following the taxable year for which the revocation was made.

If a taxpayer who elects to exclude foreign earned income becomes a resident of the United States and then, a number of years later, moves abroad again, the election remains in effect. Accordingly, that individual would not have to reelect the exclusion for that later year. If that individual does not want to be subject to the exclusion, the individual would have to revoke the election and would be barred from reelecting the exclusion for five years. However, the Internal Revenue Service could, in determining whether to consent to a revocation of the election, take into account U.S. residence for a period of a number of years.

Exclusion for housing

In addition to the exclusion for foreign earned income, an individual may elect to exclude a portion (or, in the case of housing amounts not provided by an employer, elect to deduct an amount) of his income attributable to his housing expenses. The amount of the exclusion is equal to the excess of the taxpayer's "housing expenses" over a base housing amount.

The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by, or on behalf of, the individual for housing for the individual (and for his spouse and dependents, if they reside with him) in a foreign country. The term includes expenses attributable to the housing, such as utilities and insurance, but does not include interest and taxes, which are separately deductible. If the taxpayer maintains a second household outside the United States for a spouse and dependents who do not reside with the taxpayer because of adverse living conditions, then the housing expenses of the second household also are eligible for the exclusion. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The base housing amount is 16 percent of the salary of an employee of the United States whose salary grade is step 1 of grade GS-14. Currently, this salary is $39,689, and thus the current base housing amount would be $6,350.

If an individual has salary or income from the performance of personal services abroad and housing expenses, the individual can exclude the housing under the foreign earned income exclusion. The total amount of the two exclusions combined cannot exceed the total of the individual's foreign earned income for the year. For example, if in 1982 an individual has salary of $68,000 and employer-provided housing with a value of $10,000, the individual could

exclude $78,000 (the $75,000 foreign earned income exclusion plus the excess of the individual's housing expense over the base housing amount or $3,650 ($10,000 less $6,350) but limited to foreign earned income of $78,000 ($68,000 salary plus $10,000 housing)). For a further example, if the individual described in the preceding sentence had a salary of $70,000 rather than $68,000 the individual would exclude $78,350 (the $75,000 foreign earned income exclusion plus the excess of the individual's housing expense over the base housing amount or $3,650 ($10,000 less $6,350)).

Deduction for housing

Housing costs attributable to amounts provided by an employer of the individual in the course of employment are excluded from gross income of the employee. Reimbursements by the employer for appropriate expenses incurred by the employee are amounts provided by an employer. Amounts not attributed to an employer are to be allowed as a deduction in computing adjusted gross income of the employee. The amount of this deduction is limited, subject to a special carryover rule, to the foreign earned income of the individual which is not otherwise excluded from gross income under this provision.

For example, if an individual who is not an employee has foreign earned income in 1982 of $100,000 and qualifying housing expenses in excess of the base amount of $20,000, the individual may elect to exclude $75,000 under the general exclusion and to deduct $20,000 for the excess housing cost exclusion. If, however, that individual had no nonexcluded foreign earned income for the year, then the individual could not deduct any amount attributable to the housing expenses for the year. However, the special carryover rule may allow the individual to deduct all or a portion of unused housing expenses in the next taxable year.

The Act provides that an individual who is not an employee and who qualifies for the foreign earned income exclusion, but who has housing expenses in excess of nonexcluded earned income for a year, can carry those expenses forward only to the next taxable year and deduct them in that year subject to the limitation in the next year. In determining how much of the carried forward housing expenses could be used in that next year, the carried-over amounts could be used only after the housing expenses incurred in that year.[1]

Other rules

Deductions, exclusions, or credits are not allowed to the extent properly allocable to or chargeable against amounts excluded from gross income or deductible under this provision. For example, foreign taxes paid on excluded income may not be credited against U.S. taxes or deducted from gross income. However, amounts which are made deductible or excludable by the Act by reason of

[1] For example, assume that *A*, a U.S. citizen, is a bona fide resident of a foreign country for all of 1983. *A* has no foreign earned income and his housing cost amount (his foreign housing expenses over the base amount) is $30,000. *A* gets no deduction for housing costs in 1983. In 1984, *A* has foreign earned income of $150,000 and his housing cost amount is again $30,000. *A* would be entitled to an exclusion of $85,000 plus a deduction of his $30,000 housing cost amount paid in 1984. In addition, *A* would be permitted to deduct the $30,000 of his unused housing cost amount carried over from 1983.

residence abroad are not considered allocable to the exclusion or deduction under this provision. Thus, for example, the exclusion for amounts attributable to living in a camp in a foreign country or the amount deductible as a housing cost amount not provided by an employer are not reduced because of the amount of excluded earned income.

The Act extends the benefits of the exclusion to individuals who receive compensation from the U.S. or any agency thereof and who are not employees of the U.S. or an agency thereof. Thus, for example, the Act extends the exclusion to certain overseas independent contractors and teachers at certain schools for U.S. dependents who are not employees of the U.S. or any agency thereof.

Under the Act, if an individual who has earned income from sources within a foreign country submits a statement to that country that he or she is not a resident of that country, and the individual is, in fact, held not subject to tax by that country (by its authorities) as a resident on those earnings, then the individual is not a *bona fide* resident of a foreign country for purposes of this exclusion.

The Act retains, with certain modifications, the rule that in the case of an individual who is furnished lodging in a camp located in a foreign country by or on behalf of his employer, the camp shall be considered part of the business premises of the employer for purposes of section 119 (relating to the exclusion from income of the value of meals and lodging furnished by the employer). To qualify as a camp, the lodging must be furnished for the convenience of the employer because the place at which the services are rendered is in a remote area where satisfactory housing is not otherwise available on the open market. The lodging must also be located, as near as practicable, in the vicinity of the site at which the individual performs the services and must be in a common area, or enclave, which is not available to the public and which normally accommodates ten or more employees. This provision differs from prior law primarily in that the camp does not have to be in a hardship area and need not constitute substandard lodging.

The Act retains the prior law rules under which an individual is allowed pro rata benefits in certain cases where civil unrest or similar adverse conditions require an individual to leave the foreign country before meeting the time requirements.

The Act authorizes the Treasury Department to issue such regulations as may be necessary or appropriate to carry out the purposes of these provisions, including regulations providing rules for cases in which both spouses have foreign earned income or file separate returns.

The rule extending the period within which capital gain on the sale of a principal residence must be rolled over to qualify for exemption from tax is retained.

The provisions do not affect the treatment of amounts received since December 31, 1962 which are attributable to services performed on or before December 31, 1962, and with respect to which there existed on March 12, 1962 a right (whether forfeitable or nonforfeitable) to receive such amounts. Accordingly, these amounts will continue (as they have since 1962) to be subject to

section 911 as in effect before amendment by the Revenue Act of 1962.

Finally, the provision of the Foreign Earned Income Act of 1978 requiring the Treasury to report biannually to the Congress on the operation and effect of sections 911 and 912 is changed to require the report as soon as practicable after enactment and each fourth calendar year thereafter.

Effective Date

The provisions apply to taxable years beginning after December 31, 1981.

Revenue Effect

The provisions are estimated to reduce fiscal year budget receipts by $299 million in 1982, $544 million in 1983, $563 million in 1984, $618 million in 1985, and $696 million in 1986.

C. Miscellaneous Provisions

1. Charitable contributions deduction for nonitemizers (sec. 121 of the Act and secs. 57, 63, and 170 of the Code)*

Prior Law

Under prior law, a deduction for charitable contributions could be claimed by an individual taxpayer only as an itemized deduction from adjusted gross income in determining taxable income. The amount of the itemized deduction is subject to limitations depending on the nature of the contribution, the type of donee, and the amount of the contribution in relation to the taxpayer's adjusted gross income. Under Treasury regulations, charitable deductions are subject to certain substantiation requirements.

Reasons for Change

The Congress was concerned that many individuals who make charitable contributions did not receive a full tax benefit from those contributions under prior law.

For an individual to receive a tax benefit from charitable giving under prior law, the individual must have been able to itemize deductions. This meant that the amount of charitable contributions, along with other itemized deductions, must have exceeded the individual's zero bracket amount ($3,400 for joint returns) before any tax benefit from the contributions was realized. The amount of tax benefit then realized depended on the individual's marginal tax rate. (For example, if an itemizer in the 50-percent marginal tax bracket made a contribution of $1,000, his or her tax liability generally would be reduced by $500 as a result of the contribution.) Individuals who could not itemize deductions, because they did not have deductions in excess of their zero bracket amount, realized no tax benefit from charitable contributions.

The Congress believed that allowing a charitable deduction to nonitemizers stimulates charitable giving, thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by the Federal Government.

This provision terminates after 1986, so that the Congress will have the opportunity to review its effectiveness in stimulating contributions and any administrative problems it may have caused. In addition, because it is expected that this provision will be widely used to claim deductions of relatively small amounts (e.g., no more than $25 is allowed as a deduction in 1982), the Congress intends that the Treasury Department (Internal Revenue Service) may prescribe rules and procedures, in addition to the currently applicable

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7960 (daily ed. July 20, 1981); H.R. 4242, as passed by the House (July 29, 1981), sec. 121; and H. Rep. No. 97-215 (August 1, 1981), pp. 201-202 (Joint Explanatory Statement of the Committee of Conference).

requirements for deduction of charitable contributions, to assure substantiation and verification of charitable deductions.

Explanation of Provision

The Act provides a new deduction from adjusted gross income for charitable contributions made by individual taxpayers who do not itemize deductions, phased in over a five-year period (sec. 170(i)). No change is made in the deduction for charitable contributions of individual taxpayers who itemize deductions.

For the years 1982–1984, the amount of contributions nonitemizers are allowed to take into account is subject to a dollar cap. In addition, in the years 1982–1985, only a percentage of the amount of contributions otherwise deductible is allowed as a deduction to nonitemizers. The percentages and dollar caps are shown in the following table:

Year	*Percentage*	*Contribution cap*
1982	25	$100
1983	25	100
1984	25	300
1985	50	.....
1986	100	.....
1987	(1)	(1)

[1] Provision expires.

Thus, in 1982 and 1983, nonitemizers will be allowed to deduct 25 percent of the first $100 of charitable contributions, for a maximum deduction of $25. In 1984, the maximum deduction will be $75. The dollar caps shown in the table apply to single returns and joint returns; that is, the cap is not doubled for joint returns. For married taxpayers filing separately, the applicable cap is half the amount shown in the table.

The new deduction for nonitemizers is subject to the tax rules generally applicable to charitable deductions, such as the limitations on deductibility based on the donor's adjusted gross income and the reduction in deductible amount for gifts to certain categories of donees or gifts of certain types of property.

The Treasury Department (Internal Revenue Service) may use its authority under the Code to prescribe additional regulations, rules, and tax return requirements as needed to assure substantiation and verification of charitable deductions.

Effective Date

The provision applies to contributions made after December 31, 1981, and before January 1, 1987, in taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $26 million in 1982, $189 million in 1983, $219 million in 1984, $681 million in 1985, and $2,696 million in 1986.

2. Gain on sale of residence

a. Extension of time period for rollover of gain on sale of principal residence (sec. 122 of the Act and sec. 1034 of the Code)*

Prior Law

Prior and present law provide for the nonrecognition, or "rollover," of gain on the sale of a taxpayer's principal residence if a new principal residence is purchased and used by the taxpayer within a specified period beginning before, and ending after, the date of sale (sec. 1034). This rule applies only to the extent that the purchase price of the replacement residence equals or exceeds the sale price of the residence sold.

Under prior law, the replacement period began 18 months before the sale of the principal residence and ended 18 months after the sale. Nonrecognition treatment generally was available only once during any 18-month period.[1] Thus, if nonrecognition treatment applied to a sale of the taxpayer's residence, rollover treatment would not be available for any additional residence sales during the 18-month period following the sale of the old residence.

Reasons for Change

The Congress concluded that the residential rollover period should be extended to provide taxpayers with additional time to sell their old principal residences or to acquire new ones, in light of high mortgage interest rates and the resulting difficulties in acquiring replacement principal residences and in selling existing principal residences.

Explanation of Provision

The Act extends the 18-month replacement period for nonrecognition of gain on the sale of a principal residence to two years. Thus, a taxpayer may roll over gain on the sale of a principal residence if he or she purchases and uses a new principal residence within a period beginning two years before, and ending two years after, the sale. Conforming changes are made so that nonrecognition treatment generally is available only once during any two-year period.[2]

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 151; H. Rep. No. 97-201 (July 24, 1981), p. 64; H.R. 4242, as passed by the House (July 29, 1981), sec. 122; and H. Rep. No. 97-215 (August 1, 1981), p. 202 (Joint Explanatory Statement of the Committee of Conference).

[1] However, special rules allowed nonrecognition treatment more than once in an 18-month period in certain situations where taxpayers relocate for employment purposes (secs. 1034 (c)(4) and (d)(2)).

[2] The special rules relating to relocations for employment purposes were retained (secs. 1034 (c)(4) and (d)(2)).

Effective Date

The provision applies to "old residences" (as defined in sec. 1034(a)) sold or exchanged after July 20, 1981. In addition, the provision applies to old residences sold or exchanged on or before July 20, 1981, if the 18-month rollover period expires on or after that date.[3]

Revenue Effect

The reduction in budget receipts resulting from the provision is estimated to be negligible in fiscal year 1981, and less than $10 million annually thereafter.

b. Increase in one-time exclusion of gain on sale of principal residence (sec. 123 of the Act and sec. 121 of the Code)*

Prior Law

Under prior law, individuals age 55 or older could elect to exclude, on a one-time basis, up to $100,000 of gain on the sale of their principal residences. Generally, the property must be owned and used as a principal residence for three years or more out of the five-year period preceding the sale in order for this treatment to apply.

Reasons for Change

The Congress believed that the amount of gain excludable from the sale of a principal residence should be increased to reflect more appropriately the current costs of residential property.

Explanation of Provision

The Act increases from $100,000 to $125,000 the amount of gain excludable from gross income on the sale or exchange of a principal residence by an individual who has attained the age of 55. No other changes are made to prior law.

Effective Date

The provision is effective for a sale or exchange of a principal residence after July 20, 1981.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by a negligible amount in 1981, $18 million in 1982, $53 million in 1983, $63 million in 1984, $76 million in 1985, and $91 million in 1986.

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[3] The operation of this effective date may be illustrated by the following example. Assume that a taxpayer sold his old residence on February 1, 1980, and had not purchased a replacement residence before the expiration of the prior law rollover period (i.e., August 1, 1981). Under the Act, that taxpayer is given until February 1, 1982 to secure a replacement residence in order to qualify under section 1034.

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 152; H. Rep. No. 97-201 (July 24, 1981), p. 65; H.R. 4242, as passed by the House (July 29, 1981), sec. 123; and H. Rep. No. 97-215 (August 1, 1981), p. 202 (Joint Explanatory Statement of the Committee of Conference).

3. Increase in and modification of child and dependent care credit; exclusion from income of employer payments for dependent care assistance (sec. 124 of the Act and sec. 44A and new sec. 129 of the Code)*

Prior Law

Prior law provided a tax credit equal to 20 percent of employment-related dependent care expenses paid by an individual who maintains a household which includes one or more qualifying individuals. A qualifying individual is: (1) an individual who is under the age of 15 and for whom the taxpayer may claim a dependency exemption; (2) a physically or mentally incapacitated dependent; or (3) a physically or mentally incapacitated spouse.

Employment-related expenses (which could not exceed $2,000, if there was only one qualifying individual, or $4,000, if there were two or more qualifying individuals) are expenses for household services and expenses for the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. Employment-related expenses which are incurred for services provided outside the taxpayer's household could be taken into account only if incurred for the care of an individual under the age of 15 who is a dependent of the taxpayer.

The maximum dependent care credit was $400, in the case of one qualifying individual, and $800, in the case of two or more qualifying individuals. The credit may not exceed tax liability. Also, the employment-related expenses that are taken into account for purposes of the credit generally may not exceed earned income, in the case of an unmarried individual, or the earned income of the lesser-earning spouse, in the case of a married couple. Married couples must file a joint return in order to claim the credit.

Prior law did not provide an exclusion of employer payments for dependent care from income or employment taxes.

Reasons for Change

The child and dependent care credit had not been increased since 1976, even though employment-related expenses have increased substantially since that time. Because of this, and because the Congress believed that the child care credit provides a substantial work incentive for families with children, the Act increases the amount of expenses for which the credit may be claimed.

The increases in the credit percentage are directed toward low- and middle-income taxpayers because the Congress believed that these taxpayers are in greatest need of relief. This targeting is accomplished by a sliding-scale credit which phases down from 30 percent to 20 percent as income rises from $10,000 to $28,000.

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S. 8443-45 (daily ed. July 24, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 123; H. Rep. No. 97-201 (July 24, 1981), pp. 56-57; and H. Rep. No. 97-215 (August 1, 1981), pp. 200-201 (Joint Explanatory Statement of the Committee of Conference).

In the case of two-earner married couples with children, this provision, along with the new deduction for two-earner married couples, will provide substantial tax reduction, especially at lower income levels.

The Congress believed that the tax system should provide incentives for employers to become more involved in the provision of dependent care for their employees. Thus, the Act provides that, under certain conditions, employer payments for dependent care assistance will be exempt from income and payroll taxes.

Explanation of Provision

Changes in credit

The Act increases the amount of the child and dependent care credit by increasing the percentage amount of the credit for taxpayers with adjusted gross income of $28,000 or less and by increasing the amount of employment-related expenses that may be taken into account for purposes of the credit. In addition, the Act relaxes the restriction on claiming the credit for dependent care services provided outside the home, but requires that payments to a dependent care center are eligible for the credit only if the center complies with applicable State and local regulations.

The Act increases the amount of employment-related expenses that may be taken into account for purposes of the credit from $2,000 to $2,400, if there is one qualifying individual, and from $4,000 to $4,800, if there are two or more qualifying individuals. The percentage amount of the credit is increased from 20 percent to 30 percent for individuals who have $10,000 or less of adjusted gross income. Thus, the maximum credit is $720 if there is only one qualifying individual, or $1,440 if there are two or more qualifying individuals.

The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $10,000. (For this purpose, a married couple's combined adjusted gross income is the relevant amount, since married couples must file a joint return in order to claim the credit.) For example, an otherwise qualified individual with $11,000 of adjusted gross income will be entitled to a credit equal to 29 percent of employment-related expenses. Likewise, an individual with $20,000 of adjusted gross income will be entitled to a credit equal to 25 percent of employment-related expenses. Individuals with more than $28,000 of adjusted gross income are entitled to a credit equal to 20 percent of employment-related expenses. For those individuals, the maximum credit is $480 (one qualifying individual) or $960 (two or more qualifying individuals).

The Act provides that employment-related expenses which are incurred outside the taxpayer's household may be taken into account if they are for the care of a physically or mentally incapacitated spouse or dependent of the taxpayer who regularly spends at least eight hours each day in the taxpayer's household, i.e., who lives with the taxpayer. This provision is intended to allow the credit for out-of-home care, during the day, of an individual who returns to the taxpayer's home each night, but the credit is not allowed for residential or institutional care.

The Act provides that expenses incurred for services provided outside the taxpayer's household by a dependent care center are to be taken into account only if the center complies with all applicable State and local laws and regulations. For purposes of this provision, a dependent care center is any facility which provides care for more than six individuals (other than residents) and receives a fee, payment, or grant for providing services for any of the individuals.

Exclusion of dependent care assistance

In general

The Act excludes from an employee's gross income amounts paid or incurred by an employer for dependent care assistance provided to an employee if the assistance is provided under a dependent care assistance program which meets certain conditions (new sec. 129).

The amount excluded in any taxable year may not exceed the earned income of the employee, or if the employee is married, the lower of the earned income of the employee or the earned income of the spouse. Thus, this exclusion generally is not available to one-earner couples. If the spouse is a full-time student or incapable of caring for himself or herself, that spouse is deemed to have a certain amount of income for each month the spouse meets this requirement. The amount of deemed income is $200 per month if there is one dependent or spouse being cared for, or $400 per month if there are two or more such individuals. Earned income includes wages, salaries, other employee compensation, and net income from self-employment, except for dependent care assistance and the exclusions defined for purposes of the earned income credit.

Dependent care assistance eligible for the exclusion is those amounts which, if paid for by the employee, would be eligible employment-related expenses under the child and dependent care credit. The exclusion is not available, however, if the payments are to a dependent for whom a personal exemption deduction was allowable to the employee or his or her spouse or if the payments are to the employee's child under the age of 19. No deduction or credit is allowed to the employee for any amount excluded from income under this provision. However, the Congress intended that the employer could treat such amounts as compensation which is deductible under section 162.

Qualification requirements

In order to be a qualified program, a dependent care assistance program also must meet requirements with respect to nondiscrimination in eligibility. The Act requires that a program must benefit employees who qualify under a classification set up by the employer and found by the Treasury Department not to be discriminatory in favor of employees who are officers, owners, highly compensated individuals, or their dependents.

The program must be available to a broad class of employees rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that dependent care assistance benefits were the subject of good faith bargaining between the unit

and the employer or employers offering the program. The Act specifically provides that a program shall not be considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class.

However, the operation of a program is discriminatory if more than 25 percent of the benefits are paid for shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than five percent of the stock or of the capital or profits interest in the employer.

Reasonable notification of the availability and terms of the program must be provided to eligible employees. Also, by January 31 of each year, a written statement must be furnished to each employee receiving assistance under the plan; the statement is to show the amounts paid or expenses incurred by the employer in providing dependent care assistance to the employee during the previous calendar year. Under existing regulatory authority, the Treasury Department may require that a copy of this statement is to be furnished to the Internal Revenue Service.

An individual who qualifies as an employee within the definition of section 401(c)(1) also is an employee for purposes of these provisions. Thus, in general, the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is treated as an employee under the definition in the previous paragraph.

For determining stock ownership in corporations, this provision adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The Act also provides that amounts excluded from income as dependent care assistance are not to be treated as wages subject to withholding of Federal income tax nor as wages subject to employment taxes.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $19 million in 1982, $191 million in 1983, $237 million in 1984, $296 million in 1985, and $356 million in 1986.

4. Deduction for certain adoption expenses (sec. 125 of the Act and new sec. 222 of the Code)*

Prior Law

Under prior law, there was no provision allowing the deduction of expenses paid or incurred in connection with adopting a child. These expenses, rather, were treated as nondeductible, personal expenses.

Reasons for Change

The Congress was concerned with obstacles to the adoption of children who have special needs which make them hard to place, even without regard to the high cost of adoption. Accordingly, the Act provides a limited deduction intended to encourage, and reduce the financial burdens in connection with, the adoption of children who have special needs.

Explanation of Provision

The Act provides a new itemized deduction for qualified adoption expenses paid or incurred by an individual (new sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed $1,500.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to the legal adoption of a child with special needs. The term "child with special needs" means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.[1] In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be adopted unless adoption assistance is provided. A refusal of adoption assistance payments by an individual to whom such payments are made available will not preclude the deduction.

Effective Date

The provision applies to taxable years beginning after December 31, 1980.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8602-06 (daily ed. July 28, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 286 (Joint Explanatory Statement of the Committee of Conference).

[1] Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $9 million in 1982, $9 million in 1983, $10 million in 1984, $11 million in 1985, and $12 million in 1986.

5. Imputed interest on installment sales of land between related individuals (sec. 126 of the Act and sec. 483 of the Code)*

Prior Law

Background

Section 483 generally provides that if the total deferred payments of the sales price under a contract for the sale or exchange of property include any unstated interest, a portion of each deferred payment will be treated as interest instead of sales price (sec. 483(a)). Section 483 generally applies to payments made under a contract for the sale or exchange of property that are made more than six months after the date of the sale or exchange, if at least one payment is due more than one year after the date of the sale or exchange. Section 483 does not apply to certain deferred payments under contracts for the sale or exchange of property, such as contracts with a sales price that cannot exceed $3,000, certain sales or exchanges of patents, and sales or exchanges that result only in ordinary income to the seller (sec. 483(f)).

In determining whether the total deferred sales price payments include any unstated interest, the total deferred payments of sales price are compared to the sum of the present values of such payments plus the present values of any stated interest payments due under the contract (sec. 483(b)). If the total deferred sales price payments exceed the total present values of sales price and stated interest payments, there is unstated interest.

The present value of a deferred payment is the amount that the parties would agree to pay and receive today instead of waiting for the deferred payment. The determination of this value depends on two factors. The first is the length of time until the deferred payment is to be made. The second factor is the interest rate that represents the value of money over that period.

Present values are determined by discounting payments at an interest rate prescribed in Treasury regulations (sec. 483(b)). Under regulations that took effect July 1, 1981, the interest rate used to determine whether there is unstated interest is nine percent simple interest. This rate is referred to as the "test rate."

Interest calculation

To determine how much of a deferred sales price payment is to be treated as interest, a calculation is made similar to the one used to determine whether there is unstated interest. The only difference is that the interest rate used is one percentage point higher than the test rate. This rate is referred to as the "imputed rate" and is ten percent under existing regulations.

The interest rates used to determine whether there is unstated interest and how much sales price is to be treated as interest must

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8596 (daily ed. July 28, 1981); and H. Rep. No. 97-215 (August 1, 1981), p. 281 (Joint Explanatory Statement of the Committee of Conference).

be prescribed in Treasury regulations. These interest rates have been adjusted periodically by the Treasury to reflect the prevailing rate of interest in the country.

When the Treasury has established the test rate and imputed rate to be used under section 483, a single test rate and a single imputed rate have been prescribed. Although prevailing interest rates depend on the location of the lender, the kind of property sold, or the credit worthiness of the borrower, prior law contemplated establishment of a single test rate and a single imputed rate.

Reasons for Change

The Congress concluded that the use of a single test rate in times of unusually high interest rates placed an undue burden on sales of land between related individuals. In addition, since land is not depreciable, the buyer will prefer that more of the monthly payment be treated as a deductible interest payment rather than a non-depreciable capital investment; therefore, the Congress believed interest rates are less likely to be understated in land sales.

Explanation of Provision

The Act provides that the maximum interest rate used in determining the total stated interest on "qualified sales" shall not exceed seven percent compounded semiannually (new sec. 483(g)). As a result, the test rate applied to qualified sales will not exceed six percent compounded semiannually.

A qualified sale is defined as a sale or exchange of land between members of the same family (within the meaning of sec. 267(c)(4)). The availability of the seven-percent rate is limited to the first $500,000 of qualified sales between the same family members in any calendar year. This $500,000 limit is to be applied by reference to the sales price of land sold or exchanged.

The new provision does not apply to sales or exchanges if any party to the sale or exchange is a nonresident alien individual.

Effective Date

The provision applies to payments made after June 30, 1981, pursuant to sales or exchanges after that date.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by a negligible amount in fiscal year 1981 and by less than $5 million annually thereafter.

6. State legislators travel expenses (sec. 127 of the Act and sec. 162(h) of the Code)*

Prior Law

Background

An individual is allowed a deduction for traveling expenses (including amounts expended for meals and lodging) while away from home overnight in pursuit of a trade or business (sec. 162(a)). These expenses are deductible only if they are reasonable and necessary in the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable as deductions. In addition, except as expressly allowed under the Code, no deductions are allowed for personal, living, and family expenses (sec. 262). Moreover, deductible "away from home" expenses exclude commuting costs.

Generally, under section 262, expenses and losses attributable to a dwelling unit which is occupied by a taxpayer as his or her personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions (secs. 163, 164, and 165).

A taxpayer's "home", for purposes of the deduction of traveling expenses, generally means the taxpayer's principal place of business or employment. If a taxpayer has more than one trade or business, or a single trade or business which requires spending a substantial amount of time at two or more localities, "home" is the taxpayer's principal place of business. A taxpayer's principal place of business is determined on an objective basis, taking into account the facts and circumstances in each case. The more important factors considered in determining the taxpayer's principal place of business (or tax home) are: (1) the total time ordinarily spent by the taxpayer at each of his or her business posts, (2) the degree of business activity at each location, (3) the amount of income derived from each location, and (4) other significant contacts of the taxpayer at each location. No one factor is determinative.[1]

State legislators

Prior to the Tax Reform Act of 1976, there was no special rule for ascertaining the location of a State legislator's tax home. As a result, the generally applicable rules, described above, determined the location of a State legislator's tax home.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8343-8344 (daily ed. July 24, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 802; H. Rep. No. 97-201 (July 24, 1981), pp. 265-268; H.R. 4242, as passed by the House (July 29, 1981), sec. 802; and H. Rep. No. 97-215 (August 1, 1981), p. 268 (Joint Explanatory Statement of the Committee of Conference).

[1] *See Montgomery* v. *Comm'r*, 532 F.2d 1088 (6th Cir. 1976), *aff'g*, 64 T.C. 175 (1975). In *Montgomery*, the Sixth Circuit affirmed the Tax Court's finding that a Michigan legislator's tax home was in Lansing, rather than in the Detroit district represented. As a result, the legislator was not "away from home" overnight for purposes of deducting expenses under sec. 162.

The Tax Reform Act of 1976 provided an election for the tax treatment of State legislators for taxable years beginning before January 1, 1976. This was extended for one year by the Tax Reduction and Simplification Act of 1977 to taxable years beginning before January 1, 1977, and was extended further by Public Law 95-258 to taxable years beginning before January 1, 1978. Public Law 96-167 again extended the State legislator election to taxable years beginning before January 1, 1981.

Under this election, a State legislator could treat his or her place of residence within the legislative district as his or her tax home for purposes of computing the deduction for living expenses. If this election was made, the legislator was treated as having expended for living expenses an amount equal to the sum of the daily amount for per diem generally allowed to employees of the U.S. Government for traveling away from home, multiplied by the numbers of days during that year that the State legislature was in session, including any day in which the legislature was in recess for a period of four or fewer consecutive days. For this purpose, the rate of per diem to be used was to be the rate that was in effect during the period for which the deduction was claimed. If the State legislature was in recess for more than four consecutive days, a State legislator could count each day in which his or her physical presence was formally recorded at a meeting of a committee of the State legislature.

These limitations apply only with respect to living expenses incurred in connection with the trade or business of being a legislator. The 1976 Act did not impose a limitation on living expenses incurred by a legislator in connection with a trade or business other than that of being a legislator. As to any other trade or business, the ordinary and necessary test of prior law continues to apply.

The State legislator provision of the 1976 Act was construed by the U.S. Tax Court in *Eugene A. Chappie* v. *Commissioner*, 73 T.C. 823 (1980). In that case, the Tax Court held that the generally applicable business deduction rules (sec. 162) required a California Assemblyman to be away from home overnight in order to be entitled to a business deduction for traveling and living expenses. Because section 604 of the Tax Reform Act of 1976 made no change in this rule for State legislators, the Tax Court held that no deduction was available as to days when a legislator actually was not away from his tax home (i.e. his place of residence in the district represented) overnight. The Court explained that the rules pertaining to business deductions and commuting expenses (secs. 162 and 262) precluded a deduction for expenditures incurred in the legislator's travels to and from Sacramento.

Reasons for Change

The Congress concluded that the elective provisions of the Tax Reform Act of 1976 pertaining to State legislators should be modified and made permanent. The Congress also decided that a special exception should be made for State legislators by not applying the generally applicable away from home overnight test of section 162.

The Congress recognized that State legislators may not have been aware of the application of this test to business expenses

generally. To compensate for this as to taxable years beginning on or after January 1, 1976, the Congress decided to apply the rules of the new provision to all post-1975 years.

Explanation of Provision

The Act modifies, and makes permanent, provisions similar to the provisions of the Tax Reform Act of 1976 which relate to a State legislator's annual election to treat his or her place of residence within the legislative district represented as his or her tax home.

The Act allows a State legislator to elect, for any taxable year, to treat his or her residence within the legislative district represented as his or her "tax home" for purposes of computing the deduction for living expenses allowed under section 162. An electing legislator is treated as having expended for living expenses (incurred in connection with the trade or business of being a legislator) an amount equal to the sum determined by multiplying each of the individual's legislative days during the taxable year by the greater of: (1) the amount generally allowable with respect to such a day to employees of the executive branch of the State of which the individual is a legislator for per diem while away from home, or (2) the amount generally allowable for per diem with respect to such day to employees of the U.S. Government for traveling away from home. A State per diem allowance is taken into account only to the extent that it does not exceed 110 percent of the Federal per diem.

Under the Act, an electing State legislator is deemed to have expended for business purposes an amount equal to the appropriate per diem times the legislator's legislative days for the taxable year. In addition, an electing legislator is deemed to be away from home in the pursuit of a trade or business on each legislative day. This is an exception to the general rules of section 162.

As a result, an electing legislator is entitled to a deduction equal to that computed under the statutory formula. Because such an individual is deemed to be away from home in the pursuit of a trade or business while incurring the deemed expenses, such an electing legislator is not required to be present at the legislature for that day (or for any day in a legislative recess of four or fewer consecutive days), or away from home overnight. This change in effect reverses the Tax Court decision in *Chappie* v. *Commissioner,* 73 T.C. 823 (1980), as to electing State legislators, for open and future tax years. The Act, however, does not provide for opening closed years or for new elections in past years.

In determining the appropriate rate of per diem to be utilized for the deduction computation, the rate of both Federal and State per diems to be used are those rates which were in effect for the legislative days for which the deduction is claimed.

For taxable years beginning after 1980, the Act provides that the generally applicable State legislator rules do not apply to any legislator whose actual home within the district represented is 50 miles or less from the State capitol building. The 50 miles is to be determined by measuring the actual distance a legislator would be required to travel by surface transportation between his or her district residence and the State capitol building. As a result, such legislators may not elect to have this provision apply to them.

Instead, such legislators must establish the location of their tax homes under the generally applicable facts and circumstances test. In addition, legislators excluded by this 50-mile test may not use the statutory formula for computing deductible business expenses. Rather, these legislators are subject to the business expense tests of sections 162 and 274.

Effective Date

The provision generally is effective for taxable years beginning on or after January 1, 1976.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $9 million in 1982, $5 million in 1983, $6 million in 1984, $6 million in 1985, and $7 million in 1986.

7. Rates of tax for principal campaign committees (sec. 128 of the Act and sec. 527 of the Code)*

Prior Law

Under prior law, the taxable income of a campaign committee or other political organization was subject to the highest rate, rather than the graduated rates, of the corporate income tax.

Candidates for election to Congress must designate one "principal campaign committee" to receive contributions and make expenditures on the candidate's behalf (2 U.S.C. § 432(e)). A campaign committee may be designated as a principal campaign committee by only one candidate, and such a designated committee may not support any other candidate. A statement of the designation must be filed with the Federal Election Commission and, as appropriate, with the Clerk of the House of Representatives or the Secretary of the Senate.

Reasons for Change

When Code section 527 was enacted in 1975, the Congress believed that taxable income of all political organizations should generally be subject to income tax in the same manner as taxable income of business corporations. However, the Congress provided that the graduated corporate rates would not apply to political organization taxable income because the use of multiple committees could effectively circumvent application of the higher rates of the graduated rate structure where campaigns are managed through multiple entities.

If a political candidate is required to manage his or her campaign through one principal campaign committee, however, there is no potential for avoiding, through establishment of multiple committees, the progressive effect of the graduated rates generally applicable to corporations. Therefore, the Congress concluded that a designated principal campaign committee should be taxed at the same graduated rates as apply to corporations in general.

Explanation of Provision

The Act applies the generally applicable graduated corporate income tax rates, rather than only the highest rate, to the political organization taxable income of a Congressional candidate's principal campaign committee (sec. 527). Under the law as amended by the Act, these rates will range from 15 percent to 46 percent for taxable years beginning after 1982. (The rates will range from 16 percent to 46 percent for taxable years beginning in 1982.) Under regulations prescribed by the Treasury Department, candidates

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8356-57 (daily ed. July 24, 1981); and H. Rep. No. 97-215 (August 1, 1981), pp. 268-269 (Joint Explanatory Statement of the Committee of Conference).

must furnish the Treasury with the principal campaign committee's designation.

No change is made to prior law with respect to other campaign or political organizations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

TITLE II.—BUSINESS INCENTIVE PROVISIONS

A. Cost Recovery Provisions: Depreciation and Investment Tax Credit Revisions

(Secs. 201-211 and 213 of the Act and new sec. 168 and secs. 46, 47, 48, 57, 179, and 312(k) of the Code)*

Prior Law

a. Depreciation

Overview

Under prior law, a taxpayer was allowed as a depreciation deduction for eligible property a reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

Depreciation was based on the concept that the cost of an asset should be allocated over the period it was used to produce income. In general, property was depreciable if it was (1) used in a trade or business or for the production of income and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or obsolescence. Land, goodwill, stock, and other assets that do not have a determinable useful life or that do not decline in value predictably were not depreciable. In general, the total depreciation for an asset was limited to the cost or other basis of the property, less a reasonable estimate for salvage value.

Personal property

Useful life.—A principal method used to determine useful lives for depreciable personal property was the Asset Depreciation Range (ADR) system. Assets eligible for ADR were grouped into more than 100 classes, and a guideline life for each class was determined by the Treasury. Taxpayers could claim a useful life up to 20 percent longer or shorter than the ADR guideline life. For assets not eligible for ADR, and for taxpayers who did not elect ADR, useful lives were determined according to the facts and circumstances pertaining to each asset or by agreement between the taxpayer and the Internal Revenue Service.

Method.—Taxpayers could use the straight-line method of depreciation for all depreciable assets. Under the straight-line method,

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*For legislative background of the provisions, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 201-211, 213; S. Rep. No. 97-144 (July 6, 1981), pp. 39-68; Senate floor amendments, 127 Cong. Rec. S7857-7858 (July 17, 1981), S7983-7985 (July 20, 1981), S8213-8214 (July 23, 1981), S8537-8539 (July 27, 1981), S8580-8583, S8639-8640, S8644, S8618-8621, S8622-8624, and S8638-8639 (July 28, 1981), and S8719-8723 (July 29, 1981) (daily ed.); H.R. 4242, as reported by the House Ways and Means Committee, secs. 201-206, 261; H. Rep. No. 97-201 (July 24, 1981), pp. 66-89; H.R. 4242, as passed by the House (July 29, 1981), secs. 201-211, 213; H. Rep. No. 97-215 (August 1, 1981), pp. 206-220 (Joint Explanatory Statement of the Committee of Conference); and S. Con. Res. 30, 127 Con. Rec. S9270 (Aug. 3, 1981) and H5993 (Aug. 4, 1981) (daily ed.).

the recovery of the cost basis of an asset is spread evenly over the asset's useful life. However, the cost basis of most tangible assets with a useful life of 3 years or more also could be recovered using accelerated methods, which allocate a greater share of the deductions to the early years of the asset's useful life. The most generous accelerated methods described in section 167 were the 200-percent declining balance method and the sum of the years-digits (SYD) method.[1]

Gain on disposition and recapture.—In general, a taxpayer recognized gain or loss upon a sale or other disposition of depreciable personal property. However, under ADR, the recognition of gain or loss was postponed for assets retired for routine causes (ordinary retirements), while immediate recognition of gain or loss was required on extraordinary retirements. Similar rules also applied to taxpayers who did not use ADR but who maintained item and group accounts.

When personal property or certain items of real property described in section 1245 were sold or exchanged, any recognized gain was treated as ordinary income to the extent of any depreciation previously taken (sec. 1245). Any recognized gain that exceeded previously taken depreciation generally was capital gain.

Real property

Useful lives.—Under prior law, depreciation of real property could be determined by estimating useful lives under a facts and circumstances test or by using guideline lives prescribed under Revenue Procedure 62-21, as in effect on December 31, 1970. Guideline lives were not prescribed for real property under the ADR system, except for certain structures (such as gas stations, farm buildings, and theme park structures).

The guideline lives contained in Rev. Proc. 62-21 ranged from 40 years for apartments to 60 years for warehouses. However, based on a 1975 study by the Treasury Department's Office of Industrial Economics, average lives claimed by taxpayers for new buildings ranged from 32 years for apartments to 43 years for bank buildings. These averages reflected, in part, the fact that some taxpayers were using component depreciation.

Component depreciation.—Under the component method of depreciation, a taxpayer allocated the cost of a building to its basic component parts and then assigned a separate useful life to each of these components. These components included the basic building shell, wiring, plumbing and heating systems, roof, and other identifiable components. Each of the component parts was then depreciated as a separate item of property. The component depreciation method could be applied to both new and used property.

The use of component depreciation could reduce substantially the composite life for the entire building if its short-lived components,

[1] Under the 200-percent declining balance method, depreciation was taken at twice the straight-line rate on the capital costs that had not yet been recovered through depreciation deductions. For example, for an asset with a five-year life, the first year's deduction was 40 percent of the cost, the second year's deduction was 24 percent (40 percent of the remaining 60 percent of cost), and so forth. Taxpayers using the 200-percent declining balance method typically switched to straight-line or SYD at some point during the asset's useful life because the entire cost of an asset could not be recovered using only a declining balance method.

Under the SYD method, changing fractions were applied each year to the original cost (or other basis) of the property, reduced under prior law by estimated salvage value. The numerator of the fraction for a given year was the number of years remaining in the asset's useful life, including the year for which the deduction was being computed, and the denominator, which remained constant, was the sum of the numerals representing each of the years of the asset's estimated useful life.

such as wiring, comprised a large portion of the building's cost as compared to its long-lived components, such as the shell. However, many taxpayers did not use the component method because it was complex and, for used property, required a competent appraisal. In addition, it was difficult to audit component depreciation, and there was no assurance that the lives chosen by the taxpayer for the components would be approved by the Internal Revenue Service or the courts.

Methods.—Under prior law, allowable methods for depreciating real property depended on the use of the property and whether the property was new or used. New residential rental buildings could be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the total depreciation allowable for the first two-thirds of the property's useful life did not exceed the amount allowable for that period under the 200-percent declining balance method. A building or structure was considered to be residential rental property for the taxable year only if 80 percent or more of the gross rental income was from the rental of dwelling units. New nonresidential buildings could be depreciated under the declining balance method at a rate of up to 150 percent of the straight-line rate. Used residential property with an estimated useful life of 20 years or more could be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. In addition, an historic building that had been substantially rehabilitated could be depreciated using the methods available for new property, and thus could use the 150-percent or 200-percent declining balance method otherwise available only for new property (sec. 167(o)). Any other used property, whether residential or nonresidential, had to be depreciated under the straight-line method. Taxpayers using an accelerated method in the early years were permitted to switch to the straight-line method in the later years.

Gain on disposition and recapture.—When section 1250 real property held for more than one year was sold, any gain was treated as ordinary income to the extent the total depreciation taken exceeded the depreciation that would have been allowable had the straight-line method been used (sec. 1250). Thus, if the straight-line method was used, all gain on the sale of section 1250 real property held more than one year was capital gain. This rule was more generous than the rule for personal property, under which gain was ordinary income to the extent of all depreciation taken (sec. 1245). However, for property held for one year or less, all gain was treated as ordinary income to the extent of prior depreciation taken. For qualified low-income rental housing, the amount of depreciation subject to recapture as ordinary income when the property was sold was phased out by one percentage point for each month after the property had been held for 100 months.

Minimum tax and maximum tax

Under both prior law and present law, a 15-percent minimum tax (sec. 56) is imposed on the amount of a taxpayer's items of tax preference in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the

regular income tax in the case of a corporation or one-half of the amount of the regular income tax in the case of an individual.[2]

One of the items of tax preference subject to the minimum tax under prior law was accelerated depreciation on leased personal property.[3] The preference was the amount by which the depreciation (or amortization) allowance with respect to an asset for the year exceeded the depreciation deduction that would have been allowable if the property had been depreciated using the straight-line method over its useful life. If the leased property was depreciated under the ADR system and the taxpayer chose to use a life shorter than the midpoint life, depreciation attributable to the shorter useful life was included in the amount of the preference. Thus, additional ADR depreciation was a preference item even if the straight-line method was used. Under prior law, accelerated depreciation on leased personal property was not a preference item for corporations other than personal holding companies and subchapter S corporations.

Under prior law, another preference item was accelerated depreciation on real property. The amount of the preference was the excess of the depreciation (or amortization) allowable for the year over the depreciation that would have been allowable for the year computed using the straight-line method over the property's useful life. This item was a tax preference for all taxpayers, whether or not the property was leased.

Under prior law, the maximum marginal tax rate on taxable income from personal services was 50 percent. However, the amount of personal service income subject to the maximum tax was reduced, dollar-for-dollar, by the amount of a taxpayer's preference items. Thus, a taxpayer's preference items not only were subject to a separate minimum tax, but also could cause part of a taxpayer's personal service income to be taxed at a marginal rate greater than 50 percent.

Earnings and profits

A dividend is defined as a distribution of property (including money) by a corporation to its shareholders out of either current or accumulated earnings and profits. If a distribution exceeds the corporation's earnings and profits, the excess is a "tax-free dividend" (not currently taxable to the shareholder), which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). If a taxpayer's cost basis in stock is reduced to zero, further distributions exceeding earnings and profits are treated as capital gains.

Until 1969, earnings and profits generally were computed with reference to the method of depreciation used in computing the corporation's taxable income. A corporation's earnings and profits, therefore, were reduced by the amount of depreciation deducted by the corporation on its return, thereby often allowing tax-free distributions.

After 1969, a U.S. corporation had to compute its earnings and profits using the straight-line method of depreciation or a similar

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[2] This minimum tax is sometimes called the 15-percent "add-on" minimum tax and is different from the alternative minimum tax, although it has the same general purposes.

[3] For this purpose, the term "personal property" meant property which was subject to depreciation recapture under sec. 1245.

r table method such as the units-of-production method. Earnings and profits could be computed using the 20-percent useful life variance permitted under the ADR system. These rules did not apply to foreign corporations if less than 20 percent of gross income for the taxable year was derived from sources within the United States.

Assets used predominantly outside the United States

Property used predominantly outside the United States could be depreciated using the guideline lives under the ADR system, but the 20-percent useful life variance could not be used. Accelerated methods of depreciation generally could be used with respect to such property. The investment tax credit generally was not allowed for such property (sec. 48(a)(2)).

Normalization requirements for public utility property

Public utilities generally were able to use the same depreciation methods as other taxpayers. However, certain utilities (electric, water, sewage, gas distribution, gas pipeline, steam, and telephone companies) generally could use accelerated depreciation methods and the 20-percent ADR useful life variance only if the current tax reductions that resulted from using these methods were "normalized" in setting the rates charged to utility customers.

In theory, the rates charged to customers by a public utility are set at a level that permits the utility to earn a fair rate of return on its investment and recover its costs of doing business (including a ratemaking allowance for Federal income taxes plus a ratemaking allowance for depreciation). The straight-line method and relatively long useful lives are generally used to compute the ratemaking allowance for depreciation. Normalization of accelerated depreciation methods generally meant that the rates charged to utility customers would not reflect a ratemaking allowance for Federal income taxes based on the use of a depreciation method more accelerated than the depreciation method used to determine the ratemaking allowance for depreciation. Normalization of the 20-percent ADR variance generally meant that the rates charged customers would not reflect a ratemaking allowance for Federal income taxes based on useful lives shorter than the ADR guideline life or the useful life used to determine the ratemaking allowance for depreciation, whichever is shorter. Therefore, normalization generally allowed the utilities to collect revenues that reflected a ratemaking tax allowance based on straight-line depreciation and ADR midpoint lives.

The use of accelerated methods of depreciation and the ADR useful life variance for Federal income tax purposes, combined with the use of normalization accounting in ratemaking, generally resulted in an actual Federal income tax expense that was less than the ratemaking tax allowance in the early years of an asset's useful life and more than the ratemaking tax allowance in the later years of an asset's useful life. These "deferred taxes" could be viewed as an interest-free loan to the utility. The utility was able to use this money in lieu of funds that otherwise would have to have been obtained by borrowing or raising equity capital.

The normalization rules of the Code did not limit the authority of regulatory bodies to pass through these capital cost savings to utility customers; i.e., the reduction in the costs of acquiring capital could be reflected in the rates charged to utility customers. This could be done either by treating an amount of the utility's capital as cost-free in determining a fair rate of return or by excluding an amount of the utility's assets from the rate base that was permitted to earn a rate of return. In either case, the amount of capital or rate base that was given this ratemaking treatment could not exceed the amount of the deferred taxes.

The use of accelerated methods and short useful lives in ratemaking to compute the allowance for Federal income taxes is known as "flow-through" accounting, because current tax reductions are immediately reflected in lower rates to customers. Under prior law, the normalization rules in the Code generally did not apply to property that was subject to flow-through accounting before 1970 or similar property placed in service after 1969.

Retirement-replacement-betterment (RRB) property

The railroad industry generally used the retirement-replacement-betterment (RRB) method of depreciation for rail, ties, and other items in the track accounts such as ballast, fasteners, other materials, and labor costs. This method was used instead of the depreciation methods described in sections 167(b) and 167(c), which provided for an annual deduction for each item of property (sec. 167(r)).

For assets accounted for under the RRB method, when a new railroad line was laid (an "addition"), the cost (both materials and labor) of the line was capitalized. No depreciation was claimed for this original installation, but a deduction for these original costs could be claimed if this line was retired or abandoned. If the original installation was replaced with components (rail, ties, etc.) of a like kind or quality, the cost of the replacements (both materials and labor) was deducted as a current expense. When the replacement was of an improved quality, the improved portion of the replacement was a "betterment" that was capitalized, and the remainder of the replacement cost was deducted as a current expense. On the retirement or replacement of rail and other track assets, the salvage value (measured by current fair market value) of the recovered materials was treated as ordinary income.

The regular ten-percent investment credit was allowed for the cost of railroad track material, which includes ties, rails, ballast, and other track material such as bolts. The credit was allowed for costs that were capitalized (additions and betterments) as well as costs that were expensed (replacements). Some amounts treated as replacement costs under the RRB method (such as the costs of replacing bolts) might have been considered repair expenses under a conventional depreciation system and would not have been allowed the investment credit.

Additional first-year depreciation

Under prior law, there were no special provisions specifically applicable to the depreciation of assets by a small business. Thus, a small business could depreciate its assets over useful lives deter-

mined on a facts and circumstances basis, or if elected, over guideline lives prescribed under the ADR system. Depreciation methods were allowable for a small business to the same extent allowable for other taxpayers (i.e., straight-line, declining balance, etc.).

Prior law, however, did allow a deduction for additional first-year depreciation in an amount not exceeding 20 percent of the cost of eligible property. In general, depreciable property placed in service during a taxable year was eligible under the provision if it was tangible personal property with a useful life of six years or more. The cost of the property that could be taken into account could not exceed $10,000 ($20,000 for individuals who filed a joint return).[4] Thus, the maximum additional first-year depreciation deduction was limited to $2,000 ($4,000 for individuals filing a joint return).

b. Carryover periods for operating losses

In general, net operating losses and operating losses of certain insurance companies were allowed a three-year carryback and a seven-year carryover. Certain financial institutions had only a five-year carryover, but a ten-year carryback. Certain other net operating losses had special carryover periods as follows:

Taxpayer:	*Carryover period (years)*
Regulated transportation companies	9
Foreign expropriation losses	10
Cuban expropriation losses	20
Real estate investment trusts	8
General stock ownership corporations	10

c. Investment tax credit

Overview

Under both prior law and present law, for certain tangible depreciable property with a useful life of three years or more, taxpayers can claim an investment tax credit (regular credit) of up to ten percent of the cost of the property, in addition to depreciation deductions. An additional investment credit of up to one and one-half percent (ESOP credit) is available if certain requirements concerning the operation of an employee stock ownership plan are

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[4] A controlled group of corporations (with a 50-percent control test) was treated as one taxpayer and thus was entitled to have only $10,000 of eligible property each year to be apportioned among the members of the group as provided by regulations. Also, a partnership was limited to $10,000 of eligible property per year, and a member of a partnership had to aggregate his distributive share of the partnership's eligible property with his distributive share of eligible property from other partnerships and from his direct interest in section 179 property in applying the $10,000 (or $20,000) eligible property limitation.

A trust was not eligible to elect additional first-year depreciation. However, an estate could elect to take an additional first-year depreciation allowance on up to $10,000 of qualifying property. Thus, the maximum deduction available to an estate was $2,000. The amount of the allowance under section 179 apportioned from an estate to an heir, legatee, or devisee would not be taken into account by such heir, legatee, or devisee in determining the dollar limitations applicable to additional first-year depreciation on his own property.

met. An energy investment credit is available in addition to the regular and ESOP credits for certain energy property. With certain specific exceptions, buildings and their structural components do not qualify for these credits.

Useful life limitations

A ten-percent regular investment credit was allowed under prior law for assets with useful lives of seven years or more. For assets with useful lives of five or six years, only two-thirds of the investment was eligible for the investment credit (a credit of 6⅔ percent). For assets with useful lives of three or four years, only one-third of the investment was eligible for the investment credit (a credit of 3⅓ percent). No credit was allowed for assets with useful lives shorter than three years.

Recapture

The credit must be recomputed under both prior law and present law if property is disposed of prior to the end of its estimated useful life ("recapture"). Under prior law, the recomputed credit was based on the amount of credit the taxpayer would have received if the credit had been based on the actual time the property was held. The difference between the credit allowed and the recomputed credit resulted in an increase in tax for the year of recapture.

Tax liability limitation

Under both prior law and present law, the regular and ESOP investment credits may be used against the first $25,000 of tax liability plus a percentage of the excess. For 1981, the percentage is 80 percent, and for 1982 and subsequent years, the percentage is 90 percent. The energy credit may be used against 100 percent of tax liability. Increases in tax due to recapture of credits are not counted in determining the tax liability limitation.

Used property limitation

Under prior law, only $100,000 of used property per year qualified for the regular investment credit.

At-risk limitation

Prior law and present law both impose a limit on the losses from a business or income-producing activity that a taxpayer can currently deduct (sec. 465). This limit generally is the amount of the taxpayer's investment in the activity that is considered at-risk.

A taxpayer is considered not at risk to the extent there is nonrecourse financing with respect to the activity. Nonrecourse financing generally means debt the taxpayer is not personally required to repay and for which the taxpayer has not pledged his personal assets. Nonrecourse financing also means debt owed to a creditor who either has an ownership interest in the activity or who is related to the taxpayer (within the meaning of section 267(b)). Amounts invested in an activity are treated as nonrecourse financing if the taxpayer is protected against the loss of such amounts through guarantees, stop-loss agreements, or similar arrangements.

The at-risk loss limitation rules apply to most business activities, except real estate, engaged in by individuals, subchapter S corporations, and certain closely held corporations. Certain leasing activities engaged in by closely held corporations are not covered by the at-risk loss limitations.

Under prior law, there was no at-risk limit on the investment credit.

d. Carryover periods for certain credits

In general, unused tax credits, such as the investment credit, alcohol fuels credit, WIN credit, and targeted jobs credit, were allowed a three-year carryback and a seven-year carryover.

Reasons for Change

The Congress concluded that prior law rules for determining depreciation allowances and the investment tax credit needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion. The Congress also concluded that prior law rules were unnecessarily complicated.

The real value of depreciation deductions allowed under prior rules has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology. The Congress agreed with numerous witnesses who testified that a substantial restructuring of depreciation deductions and the investment tax credit would be an effective way of stimulating capital formation, increasing productivity, and improving the nation's competitiveness in international trade. The Congress, therefore, concluded that a new capital cost recovery system was required which provides for the more rapid acceleration of cost recovery deductions and maintains or increases the investment tax credit.

The Congress also heard copious testimony that the prior law rules were too complex. These rules required determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently resulted in unproductive disagreements between taxpayers and the Internal Revenue Service. Regulations under the prior rules provided numerous elections and exceptions which taxpayers—especially, small businesses—found difficult to master and expensive to apply. The Congress decided that a new capital cost recovery system should be structured which de-emphasizes the concept of useful life, minimizes the number of elections and exceptions, and so is easier to comply with and to administer.

Explanation of Provisions

a. Overview

New system of cost recovery

The Act replaces the prior law depreciation system with the Accelerated Cost Recovery System (ACRS). ACRS is a system for recovering capital costs using accelerated methods over predeter-

mined recovery periods that are generally unrelated to, but shorter than, prior law useful lives. The ACRS methods of cost recovery and recovery periods are the same for both new and used property.

ACRS is mandatory for all eligible property. The recovery allowance provided under section 168 is deemed a reasonable allowance for depreciation under section 167(a), and eligible property may not be depreciated under the prior law rules of section 167. Thus, accelerated depreciation methods permitted under section 167 cannot be used for eligible property, and useful lives based on facts and circumstances or the ADR system cannot be used. As discussed below, the repair allowance election under section 263(e) is not available for property placed in service after December 31, 1980.

Under the new system, the cost of eligible personal property must be recovered over a 15-year, 10-year, 5-year, or 3-year period, depending on the type of property. Most eligible personal property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. The 10-year class includes certain long-lived utility property, railroad tank cars, coal-utilization property, and certain real property described in section 1250(c). Other long-lived public utility property is in a 15-year class. Eligible real property is placed in a separate 15-year real property class. To provide flexibility, certain longer optional recovery periods are provided.

Recovery of costs generally is determined by using a statutory accelerated method. As an option, the taxpayer may choose to recover costs using the straight-line method over either the regular recovery period or one of the longer recovery periods provided.

The entire cost or other basis of eligible property is recovered under the new system, eliminating the salvage value limitation of prior law.

Special rules

The Act includes a provision for limited expensing of eligible property, special rules relating to cost recovery for foreign assets, normalization requirements for public utility property, and rules for computing earnings and profits and the minimum tax. Special rules also are provided to prevent the "churning" of used property between certain persons solely to obtain the benefits of increased investment incentives under ACRS. In addition, the Act provides that under a safe harbor "lease", the nominal lessor of recovery property is treated as the owner of the property for Federal income tax purposes and thus entitled to the associated cost recovery allowances and investment credits, even though the State-law owner of the property is the "lessee".

Investment tax credit

The Act revises the rules for determining the amount of credit allowed eligible recovery property and the rules for determining recapture of the credit. In addition, the Act adds two new items of eligible property, increases the used property limitation, imposes an at-risk limitation on the amount of the credit, and increases the carryover period for unused credits.

b. Eligibility

Under the Act, property eligible for ACRS generally includes tangible depreciable property (personal and real), whether new or used, placed in service after December 31, 1980. Eligible property does not include intangible depreciable property, that portion of the basis of tangible depreciable property the taxpayer properly elects to amortize (e.g., low-income housing rehabilitation expenditures), or tangible depreciable property the taxpayer properly elects to depreciate under a method not expressed in terms of years (e.g., property depreciated under the units-of-production method). The Act does not change any determination under prior law as to whether property is tangible or intangible or depreciable or nondepreciable.

The retirement-replacement-betterment (RRB) depreciation method is repealed as of January 1, 1981. Railroad property previously eligible for depreciation under the RRB method is therefore eligible property under ACRS, subject to special transitional rules, if placed in service after December 31, 1980.

In general, if the lessee makes improvements to property, the cost of the leasehold improvement is recovered by the lessee over the ACRS recovery period applicable to that property if that recovery period is shorter than the lease term. If the lease term is shorter than the recovery period, the cost is amortized in accordance with the rules under section 178. For purposes of determining whether the recovery period is longer than the lease term, an election of a longer recovery period under section 168(b)(3) or (f)(2)(C) shall be taken into account. If the lessor makes an improvement to its property, the ACRS recovery period must be used regardless of the period of time the property is leased.

c. Personal property

Classification as personal property

Personal property, as that term is used in this explanation, includes all tangible property described in section 1245(a)(3) except elevators and escalators and certain real property described in subparagraph (D) thereof. As under prior law, this property is subject to depreciation recapture under the rules of section 1245 and is generally eligible for the investment credit.

Personal property, as that term is used here, also includes residential manufactured homes that are property described in section 1250(c) and other real property described in section 1250(c) that had an ADR midpoint life of 12.5 years or less under prescribed class lives in effect on January 1, 1981 (e.g., certain theme park property). As under prior law, this property is not eligible for the investment credit. Unlike prior law, the Act provides that this property is subject to the depreciation recapture rules of section 1245.

Recovery period

Under the Act, the capital cost of eligible personal property generally is recovered over a 3-year, 5-year, 10-year, or 15-year recovery period, depending on the recovery class of the property.

Under a flexibility provision (discussed below), taxpayers may elect to recover the capital cost of personal property over one of

two longer recovery periods, as set forth below:

Regular recovery period	*Optional recovery periods*
3 years	5 or 12 years
5 years	12 or 25 years
10 years	25 or 35 years
15 years	35 or 45 years

Classification of property

3-year recovery property

All personal property with an ADR midpoint life of four years or less as in effect on January 1, 1981 (e.g., automobiles, light-duty trucks, and certain special tools) is placed in this class. Personal property used in connection with research and experimentation also is assigned to the 3-year class. (For this purpose, research and experimentation has the same meaning as has the term "research or experimental" under section 174.) In addition, race horses over two years old when placed in service by the taxpayer and other horses over 12 years old when placed in service by the taxpayer are included in the 3-year class.

5-year recovery property

The 5-year class includes all tangible personal property that is not included in the 15-year, 10-year, or 3-year recovery classes.

Single-purpose agricultural and horticultural structures and facilities (other than a building or its structural components) used for the storage of petroleum and its primary products are designated under the Act as section 1245 property and are included in the 5-year class. Under regulations prescribed by the Treasury Department, petroleum and its primary products are to have the same meaning as described in the DISC regulations (Treas. Reg. § 1.993–3(g)(3)(i)). Petrochemicals are not considered to be primary products of petroleum. Single-purpose agricultural and horticultural structures are the same structures eligible for the investment tax credit under section 48(a)(1)(D). (No inference is intended as to the appropriate depreciation and recapture treatment under prior law of single-purpose structures.)

Elevators and escalators, which are eligible for the investment credit under section 48(a)(1)(C), are treated as 15-year real property under ACRS.

10-year recovery property

The 10-year class includes public utility property with an ADR midpoint life, in effect as of January 1, 1981, of 18.5 to 25 years (other than public utility property used in connection with research and experimentation). In addition, burners and boilers (and related equipment such as fuel handling equipment) with an ADR midpoint life of more than 25 years are included in the 10-year class if the burners and boilers use coal (including lignite) as a primary fuel and either replace or are conversions of oil-fired or

gas-fired burners or boilers used in a public utility powerplant. Railroad tank cars are also included in the 10-year class.

The 10-year class also includes certain property described in section 1250(c). Residential manufactured homes that are described in section 1250(c) and other property described in section 1250(c) with an ADR midpoint life of 12.5 years or less (e.g., certain theme park structures) are included in the 10-year class. The inclusion of these types of property in the 10-year class means that they are section 1245 recovery property and therefore are subject to section 1245 recapture, as discussed below. This property remains section 1250 property for other purposes and is not eligible for the investment tax credit.

Any theme or amusement park property described in ADR class 80.0 (which has an ADR midpoint life of 12.5 years) and also described in section 1245(a)(3) (A) or (B) is included in the 5-year class.

15-year public utility property

The 15-year class includes public utility property with an ADR midpoint life, as of January 1, 1981, of more than 25 years (other than public utility property used in connection with research and experimentation included in the 3-year class and public utility coal-fired boilers and burners included in the 10-year class). This class includes, for example, most property in electric utility steam production plants, gas utility manufactured gas production plants, water utility property, and telephone distribution plants.

Method

Prescribed method

In general, the recovery deduction in each year of the recovery period is determined by applying a statutory percentage to the unadjusted basis of the property. In determining the annual deduction, the applicable percentage to be applied to the unadjusted basis of the property depends on the property's class and the number of years since the property was placed in service by the taxpayer ("recovery year"). The recovery deduction for the taxable year in which property is placed in service is based on the full recovery percentage precribed in the statutory table for the first recovery year, regardless of when the property was placed in service during the taxable year. No recovery deduction is allowable in the year of an asset's disposition.

For a taxable year that is less than 12 months, section 168(f)(5) provides that the recovery percentage that otherwise would apply (i.e., the statutory accelerated percentage or the recovery percentage based on one of the optional recovery methods) must be reduced to a percentage that bears the same relation to the otherwise applicable percentage as the number of months in the short taxable year bears to 12. In that case, the otherwise applicable recovery percentages for later taxable years in the recovery period must be adjusted appropriately in accordance with regulations prescribed by the Treasury.

The Act delegates authority to the Treasury to promulgate regulations for determining the amount of a recovery deduction when, after property is placed in service, the basis must be redetermined

(for example, when there has been a decrease or an increase in the purchase price or a reduction in basis under sec. 1017).

Three statutory schedules of recovery percentages are provided for each class of recovery property. One schedule applies to recovery property placed in service in the years 1981 through 1984. One schedule applies to recovery property placed in service in 1985. The third schedule for each class applies to recovery property placed in service after 1985.

The schedules for personal property placed in service in 1981 through 1984 were developed to approximate the benefits of using the 150-percent declining balance method for the early recovery years and the straight-line method for the later recovery years. The schedules for personal property placed in service in 1985 were developed to approximate the use of the 175-percent declining balance method for the early recovery years and the sum of the years-digits method for the later recovery years. The schedules for personal property placed in service after 1985 were developed to approximate the use of the 200-percent declining balance method for the early recovery years and the sum of the years-digits method for the later recovery years. All of the schedules reflect the allowance of only a half-year of depreciation for the first recovery year and the allowance of the remaining recovery deductions over the remaining recovery years. Thus, for example, the schedules for 5-year property provide for the allowance of a half-year of depreciation for the taxable year the property is placed in service and the allowance of the remaining recovery deductions in the succeeding four taxable years. This is not the same as the half-year convention used under prior law, which provided for the allowance of a half-year of depreciation for the taxable year the taxpayer places the property in service and also a half year of depreciation for the last taxable year of its useful life or the taxable year in which the taxpayer disposes of property.

The recovery percentages for property placed in service during each of the three periods are set forth in the following tables.

FOR PROPERTY PLACED IN SERVICE, 1981–84

[Recovery percentage]

	Class of property			
	3-year	5-year	10-year	15-year public utility property
Recovery year:				
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6

FOR PROPERTY PLACED IN SERVICE, 1981–84—Continued

[Recovery percentage]

	Class of property			
	3-year	5-year	10-year	15-year public utility property
Recovery year:				
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6
Total	100	100	100	100

FOR PROPERTY PLACED IN SERVICE IN 1985

[Recovery percentage]

	Class of property			
	3-year	5-year	10-year	15-year public utility property
Recovery year:				
1	29	18	9	6
2	47	33	19	12
3	24	25	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				4
13				3
14				2
15				1
Total	100	100	100	100

FOR PROPERTY PLACED IN SERVICE AFTER DECEMBER 31, 1985

[Recovery percentage]

	Class of property			
	3-year	5-year	10-year	15-year public utility property
Recovery year:				
1	33	20	10	7
2	45	32	18	12
3	22	24	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				3
13				3
14				2
15				1
Total	100	100	100	100

Optional methods

Taxpayers may use, in lieu of the prescribed accelerated percentages, percentages based on the straight-line method over the regular recovery period for the class or one of the two optional longer recovery periods for the class, as described above. Thus, a taxpayer can elect to use the straight-line method over three years, five years, or 12 years for 3-year property; five years, 12 years, or 25 years for 5-year property; ten years, 25 years, or 35 years for 10-year property; and 15 years, 35 years, or 45 years for 15-year public utility property.

A taxpayer electing to use an optional recovery method must elect the same recovery method for all property of that class placed in service in the year for which the election is made. The election is irrevocable. Different elections may be made for property in different classes placed in service in the same year and for property in the same class placed in service in different taxable years.

If the straight-line method is elected, a half-year of cost recovery is allowable for the year the property is placed in service and, if the property is held for the entire recovery period, a half-year of depreciation is allowable for the year following the end of its recovery period. For example, for 5-year property for which the straight-line method and a 5-year recovery period are used, a half-year of cost recovery is allowable in the first year, a full year of cost recovery is allowable in each of the next four years, and a half-year of cost recovery is allowable in the sixth year. Thus, the

recovery percentages will be 10-percent for the taxable year the property is placed in service, 20 percent for each of the next four taxable years, and 10-percent for the sixth taxable year. However, no cost recovery will be allowable to the taxpayer with respect to the property for the year of disposition or retirement.

Disposition of assets and recapture

Gain or loss generally will be recognized on each disposition of an asset, including retirements, unless other provisions of the Code provide for nonrecognition. However, taxpayers may elect to avoid calculation of gain on disposition of assets from mass asset accounts. In that case, gain is recognized to the extent of the proceeds realized from the disposition of the asset and the unadjusted basis of the property is left in the account until fully recovered in future years.

As under prior law, gain recognized on the disposition of assets will be ordinary income to the extent of prior recovery deductions taken ("section 1245 recapture"). This recapture rule applies to all recovery property in the 3-year, 5-year, 10-year, and 15-year classes for personal property. Therefore, this recapture rule applies to residential manufactured homes and theme park structures in the 10-year class, even though this property is described in section 1250(c) as section 1250 property.

Repair allowance

Under prior law section 263(e), taxpayers could elect, under regulations, to deduct repair expenses or specified repair, rehabilitation, or improvement expenditures for any class of depreciable property to the extent of a repair allowance for that class. Under the Act, the repair allowance election under section 263(e) is repealed with respect to property placed in service after December 31, 1980.

d. Real property

Classification as real property

Real property, as that term is used in this explanation, refers to property described in section 1250(c) other than property with an ADR midpoint life of 12.5 years or less as in effect on January 1, 1981, and other than residential manufactured homes. Thus, real property generally includes property described in section 1250(c) that either had an ADR midpoint life of 13 years or more as in effect on January 1, 1981, or had no ADR midpoint life as of January 1, 1981 (with relatively few exceptions, ADR lives were not assigned to buildings and structures). Real property also includes elevators and escalators described in section 1245(a)(3)(C).

Recovery period

Real property has a 15-year recovery period. As an option to the 15-year recovery period, taxpayers may elect either a 35-year or 45-year extended recovery period. The election may be made on a property-by-property basis.

Method

The taxpayer has an option to use (1) prescribed percentages based on an accelerated method over the regular 15-year recovery

period or (2) the straight-line method over either the regular 15-year period or the optional longer recovery period chosen. The election of recovery methods may be made on a property-by-property basis.

The accelerated percentages are to be determined under tables prescribed by the Treasury in accordance with the use of the 175-percent declining balance method (200 percent for low-income housing as defined in section 1250 (a)(1)(B) (i), (ii), (iii), or (iv)), switching to the straight line method at a time to maximize the recovery allowance. As discussed above in connection with personal property, section 168(f)(5) provides a rule reducing the otherwise applicable recovery percentages for taxable years that are less than 12 months. For the year of acquisition and disposition, the percentages are to be based on the number of months during those years that the property was in service.[5]

The Treasury has prescribed the following tables containing the accelerated recovery percentages for real property:

ACRS Cost Recovery Tables for Real Property

1. All 15-year real property (except low-income housing)

If the recovery year is:	The applicable percentage is: (use the column for the month in the first year the property is placed in service)											
	1	2	3	4	5	6	7	8	9	10	11	12
1	12	11	10	9	8	7	6	5	4	3	2	1
2	10	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16			1	1	2	2	3	3	4	4	4	5

2. Low-income housing

If the recovery year is:	The applicable percentage is: (use the column for the month in the first year the property is placed in service)											
	1	2	3	4	5	6	7	8	9	10	11	12
1	13	12	11	10	9	8	7	6	4	3	2	1
2	12	12	12	12	12	12	12	13	13	13	13	13
3	10	10	10	10	11	11	11	11	11	11	11	11

[5] However, it was not the intent of Congress that section 168(f)(5) apply to real property in the year of acquisition and disposition. Since for those years a month-to-month rule applies, application of the short taxable year rule would result in a double reduction of recovery percentages.

If the recovery year is:	The applicable percentage is: (use the column for the month in the first year the property is placed in service)											
	1	2	3	4	5	6	7	8	9	10	11	12
4	9	9	9	9	9	9	9	9	10	10	10	10
5	8	8	8	8	8	8	8	8	8	8	8	9
6	7	7	7	7	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	5	5	5	5	5	5	5	5	5	5	6	6
9	5	5	5	5	5	5	5	5	5	5	5	5
10	5	5	5	5	5	5	5	5	5	5	5	5
11	4	5	5	5	5	5	5	5	5	5	5	5
12	4	4	4	5	4	5	5	5	5	5	5	5
13	4	4	4	4	4	4	5	4	5	5	5	5
14	4	4	4	4	4	4	4	4	4	5	4	4
15	4	4	4	4	4	4	4	4	4	4	4	4
16			1	1	2	2	2	3	3	3	4	4

Component depreciation eliminated

The recovery period and method the taxpayer selects must be used for the building as a whole, including all structural components that are real property (e.g., wiring, plumbing, etc.). Component depreciation no longer may be used. The distinction between a structural component of a building, which is section 1250 property, and an item of property that is section 1245 property remains the same as under prior law. The taxpayer must exclude from the basis of the building recovered under ACRS any amounts the taxpayer properly elects to amortize in lieu of depreciation (e.g., low-income housing rehabilitation expenditures under section 167(k)).

The recovery period of a building begins when the building is placed in service. If a component part is placed in service before the building as a whole is placed in service, the recovery period of the component commences when the building is placed in service. If a new component is added to a building after the building is placed in service, the recovery period of the component begins when the component is placed in service. For example, if a new component is added to a building at the end of the building's 15-year recovery period, the cost of the component must be recovered over a 15-year period commencing at the time the component is placed in service.

For purposes of making the election to use an optional recovery period or method, a substantial improvement of a building is treated as a separate building. For example, the taxpayer may use a 15-year recovery period for a substantial improvement even if the rest of the building has a 35-year or 45-year recovery period. Also, the taxpayer may use an accelerated method for a substantial improvement even if the straight-line method is used for the rest of the building. Under the Act, an improvement is a substantial improvement if (a) over a two-year period the amounts added to the capital account for the building are at least 25 percent of the adjusted basis of the building (disregarding adjustments for depreciation or amortization) as of the first day of that period and (b) the improvement is made at least three years after the building is placed in service.

A special rule allows a new recovery period and method election for the first component placed in service after 1980 on a building

owned before 1981, whether or not it is a substantial improvement. The taxpayer must elect a 15-, 35-, or 45-year period for these new components of pre-1981 buildings regardless of the remaining useful life of the building. The recovery period and method selected for the new component will determine the recovery period and method for any subsequently added components that are not substantial improvements.

Gain on disposition and recapture

For the year of disposition, cost recovery is allowed for the number of months in that year the property was in service during that year (sec. 168(b)(2)(B)). For this purpose, a retirement of the building that does not involve a sale or exchange is considered a disposition (sec. 168(d)(2)(C)). Thus, an abandonment of the building is considered a disposition. Also, retiring a building to a scrap account is also considered a disposition. However, Congress did not intend a retirement of a structural component of the building to be a disposition requiring recognition of gain or loss. Thus, if the roof wears out, no loss is recognized upon retirement, and the unadjusted basis of the building is not reduced (i.e., cost recovery continues over the remaining recovery period). If the roof is replaced, the unadjusted basis of the new roof is recovered over a new recovery period beginning in the month it is placed in service.

If the cost of nonresidential property in the 15-year real property class is recovered under the prescribed accelerated method, all gain on disposition will be treated as ordinary income to the extent of all recovery allowances previously taken (sec. 1245 recapture). However, as under prior law, if the straight-line method is elected, all gain on property held for more than one year will be capital gain.

For all residential real property (as defined under prior law), gain is treated as ordinary income only to the extent the recovery allowed under the prescribed accelerated method exceeds the recovery that would have been allowable if the straight-line method over the 15-year period had been used (sec. 1250). If the straight-line method is elected, all gain on property held for more than one year will be capital gain. Thus, the recapture rules for residential real property are the same as prior law rules.

The Act retains the prior law rule that phases out recapture at one percentage point per month for qualified low-income housing after the property has been held 100 months.

If the taxpayer uses accelerated depreciation for a nonresidential building and straight-line depreciation for a substantial improvement to the building (or vice versa), all gain on a subsequent disposition of the entire building is first treated as ordinary income to the extent of all recovery allowances taken pursuant to use of the accelerated method (sec. 1245 recapture). This rule applies regardless of whether the straight-line method is used in conjunction with the regular recovery period or an optional longer recovery period. The remainder of the gain is capital gain if the property has been held for more than one year. A similar rule generally applies for components added to a building placed in service before 1981 if accelerated depreciation is taken for the components.

e. Expensing in lieu of cost recovery

Overview

The Act provides that a taxpayer (other than a trust or estate) may elect to treat the cost of qualifying property as an expense that is not chargeable to capital account. The costs for which the election is made will be allowed as a deduction for the taxable year in which the qualifying property is placed in service. The optional expensing provision applies to qualified property placed in service in taxable years beginning after 1981.

For taxable years beginning in 1982 and 1983, the dollar limitation on the amount that can be expensed is $5,000 a year ($2,500 in the case of a married individual filing a separate return). For taxable years beginning in 1984 and 1985, the dollar limitation is $7,500 ($3,750 for a married individual filing a separate return). For taxable years beginning in 1986 and later years, the dollar limitation is $10,000 ($5,000 for a married individual filing a separate return).

In general, the property for which an election may be made is property eligible to be treated as recovery property. The property must be acquired by purchase for use in a trade or business and must otherwise be eligible for the investment credit. The trade or business limitation means that the election is not available for property held merely for the production of income (sec. 212). In the case of otherwise eligible property used for both business and personal purposes, the depreciable portion of the basis of the property i.e., the portion attributable to the business use, is eligible for expensing under this provision. The requirement that the property be acquired by purchase is the same as the requirement in prior section 179 for property eligible for additional first-year depreciation. Generally, this means that acquisitions do not qualify if (1) the property is acquired from a person whose relationship to the taxpayer would result in a disallowance of loss on a transaction between the taxpayers, (2) the property is acquired by one component member of a controlled group from another component member of the same group (using a 50-percent control test), or (3) the basis of the property in the hands of the person acquiring it is determined in whole or in part (a) by reference to the adjusted basis of the property in the hands of the person from whom it was acquired or (b) under the step-up in basis rules for property acquired from a decedent.

Prior section 179 is repealed for property placed in service after December 31, 1980. Thus, neither additional first-year depreciation nor expensing is allowed for property placed in service in 1981 or taxable years beginning in 1981.

Other limitations on eligibility

Under the Act, a controlled group of corporations is subject to limitations similar to those of prior section 179. Thus, a controlled group of corporations (with a 50-percent control test) is treated as one taxpayer and must apportion the annual dollar limitation among the members of the group as provided in regulations.

Similarly, the same type of dollar limitations will apply in the case of partnerships as previously applied under section 179(d)(8).

Under the Act, as under prior section 179, both the partnership and each partner are subject to the annual dollar limitation.

Dollar limitations where property is traded in

Prior section 179 provided that the cost of property eligible for additional first-year depreciation did not include the portion of the basis of such property that is determined by reference to the basis of property traded in. The same rule is provided in the new expensing provision.

Elections

The Act provides that an election to expense property under this provision for any taxable year must specify the items of property to which the election applies and the portion of the cost of each of these items to be deducted currently. In order to provide a degree of certainty, the Act requires that an election to expense property and any specification of items or amounts contained in such an election may not be revoked except with the consent of the Treasury Department.

Treatment of expensed property on disposition

If any portion of the basis of property is expensed under the new provision, the amount expensed is treated as depreciation taken for purposes of the recapture rules of section 1245. Thus, gain recognized on disposition of the property is treated as ordinary income to the extent of amounts expensed and depreciation taken.

For a disposition that is given installment sales treatment under section 453, the Act provides that any amounts expensed for the property are immediately recaptured as ordinary income to the extent of the gain realized on the disposition. An amount equal to the amount immediately recaptured under this rule is treated as an addition to the adjusted basis of the property for determining the amount of basis recovered and gain recognized from each installment payment.

Relationship with investment tax credit

No investment tax credit is allowable for the portion of the cost of property expensed under this new rule. Similarly, Congress intended that no investment tax credit be allowed under section 48(d) to a lessee of property to the extent the lessor expensed the cost of the property.

f. Flexibility

Options available to taxpayers

As discussed above, taxpayers may use one of two optional recovery periods that are longer than the recovery period prescribed for each class of property. In addition, taxpayers have an option to use (1) an accelerated method over the regular recovery period or (2) the straight-line method over the regular or optional longer recovery periods.

As under the Treasury regulations for the ADR system, each member of an affiliated group of corporations generally may make its own flexibility elections with respect to property it places in service. However, if the affiliated group files a consolidated tax

return, the availability of separate elections will depend on the applicable consolidated return regulations prescribed by the Treasury. The provisions of the Act do not curtail Treasury authority to prescribe consolidated return rules, including those relating to cost recovery elections.

Limitation on options for certain transferees

A transferee of recovery property, in general, may elect a recovery period or method different from that elected by the transferor. However, appropriate restrictions are imposed to prevent the use of asset transfers as a mechanism to change the recovery period or method for property acquired in an intercompany transfer from another member of an affiliated group or in certain other related party transfers and nonrecognition transactions. For transfers subject to these restrictions, the transferee must "step into the shoes" of the transferor for the recovery period and method of the transferred property. This rule, which is similar to the rule that applied to section 381 transactions under prior law, applies only to the extent the basis in the transferee's hands equals the transferor's adjusted basis.

For example, assume the transferor elected to use the straight-line method and a 12-year recovery period for 5-year recovery property. Assume also that an intercompany carryover basis transfer occurred five years after the property was placed in service. The transferee must recover its basis in the property using the straight-line method over the remaining seven years of the recovery period elected by the transferor.

Transactions subject to this rule are sale-leasebacks, transfers between certain related persons, and tax-free transactions described in sections 332 (other than a transaction to which section 334(b)(2) applies), 351, 361, 371(a), 374(a), 721, or 731. However, this rule does not apply to pre-1981 property not eligible to be recovery property because of the anti-churning rules. Pre-1981 property subject to the anti-churning rules is depreciated under prior law rules. See discussion below of effective date and anti-churning rules.

Extension of carryovers

The net operating loss (NOL) and investment credit carryover periods are extended, in general, to 15 years. However, NOL's of a financial institution are carried back ten years and carried forward five years, as under prior law.

g. Earnings and profits

As under prior law, the Act provides that U.S. corporations are to compute earnings and profits using the straight-line recovery method. However, for those corporations that currently make large distributions in relation to earnings and profits, the computation of earnings and profits using the straight-line method over the generally shortened recovery periods under ACRS would greatly increase the incidence of tax-free distributions. The Act provides, therefore, that U.S. corporations will compute earnings and profits using straight-line recovery over recovery periods that are longer than the normal recovery periods used to compute recovery allowances for income tax purposes.

The extended recovery periods that will be used to compute earnings and profits are as follows:

EXTENDED RECOVERY PERIOD

Type of property:	*Years*
3-year property	5
5-year property	12
10-year property	25
15-year property	35

If, to compute the recovery deduction under new section 168, a taxpayer uses a recovery period longer than the applicable extended recovery period described above, the taxpayer must use such longer period in lieu of the regular extended period to compute earnings and profits. Thus, if a taxpayer elects to use the optional 25-year recovery period to compute the recovery deduction for 5-year property placed in service in a taxable year, the taxpayer must use the 25-year period to compute earnings and profits with respect to such property.

Under the Act, the computation of earnings and profits by foreign corporations that were not subject to the special earnings and profits rules of section 312(k) before the Act is basically unchanged. Earnings and profits for such foreign corporations will be computed in accordance with the rules provided for computing the recovery allowance for foreign assets (see "Foreign assets," below).

h. Foreign assets

Recovery period

Property used outside the United States for more than half the taxable year generally is considered a foreign asset. The investment tax credit generally is not allowed for such property (sec. 48(a)(2)). Under prior law, foreign assets were depreciated using useful lives based on facts and circumstances or the guideline lives under the ADR system, but the 20-percent useful life variance under ADR could not be used. Accelerated methods of depreciation generally could be used with respect to such property.

Under the Act, the cost of personal property used predominantly outside the United States is recovered using a recovery period equal to the ADR guideline period (midpoint life) for the property as of January 1, 1981. For personal property for which there is no ADR midpoint life as of January 1, 1981, a 12-year recovery period must be used. The applicable recovery percentages will be determined under tables prescribed by the Treasury Department. These tables are to be based on the 200-percent declining balance method for the early years of the recovery period and the straight-line method for the later years. A "half-year" convention will be used and there will be no salvage value limitation. The determination of useful lives using facts and circumstances will not be allowed.

For foreign real property, the recovery period will be 35 years. The 35-year recovery period applies to all components of the build-

ing. The applicable percentages for real property also will be determined under tables, prescribed by the Treasury, which will be based on the 150-percent declining balance method for the early years of the recovery period and the straight-line method for the later years. There will be no salvage value limitation. Useful life determinations based on facts and circumstances will not be allowed.

In determining whether property is used predominantly outside the United States, the Treasury shall prescribe regulations applying section 48(a)(2). Thus, property used predominantly outside the United States shall not be treated as a foreign asset if one of the exceptions set forth in section 48(a)(2)(B) applies. For example, if property is used in Puerto Rico by a domestic corporation that is not an electing possessions corporation under section 936 or by a U.S. citizen that does not qualify for an exemption from tax under section 933, the property will not be treated as a foreign asset (sec. 48(a)(2)(B)(vii). The Congress intends that prior law rules interpreting these exceptions shall apply.

Flexibility, other rules

To provide flexibility, the straight-line method can be used in lieu of the prescribed accelerated method. In the case of foreign personal property, the taxpayer may elect to use the straight-line method over the ADR midpoint life. The taxpayer may also elect to use the straight-line method over one of the optional recovery periods allowed for domestic recovery property but the period elected may not be shorter than the ADR midpoint life (or 12 years for property without an ADR midpoint life as of January 1, 1981). Thus, for a foreign asset that is 5-year property, the taxpayer may elect straight-line recovery over a recovery period equal to the ADR midpoint life (or 12 years if the property has no ADR midpoint life as of January 1, 1981), or if longer, 12 years or 25 years. For foreign personal property with the same ADR midpoint life and same ACRS recovery class, the taxpayer must make the same election regarding recovery periods and recovery methods with respect to all such property placed in service in the same taxable year.

For real property, the taxpayer may elect to use the straight-line method over a recovery period of 35 or 45 years. This election may be made on a property-by-property basis.

If an optional straight-line recovery is elected for personal property, the "half-year" convention will apply under regulations prescribed by the Treasury in the same manner as for domestic property. For foreign real property, recovery in the years of acquisition and disposition will be based on the number of months the property is in service during the year. In the case of property that is used by a taxpayer in the United States and then used predominantly outside the United States (or vice versa), the Congress expects the Treasury to provide regulations relating to recovery periods, recovery percentages, and flexibility elections.

The Act also liberalizes the rules applicable to railroad rolling stock used within and without the United States. Under prior law, railroad rolling stock owned by a domestic railroad and used within and without the United States was not considered a foreign

asset, even if it was used outside the United States for more than half the taxable year. The Act provides that for taxable years beginning after December 31, 1980, railroad rolling stock used within and without the United States generally is not treated as a foreign asset, whether owned by a domestic railroad or other U.S. person. However, railroad rolling stock of a U.S. person other than a domestic railroad is considered a foreign asset if it is leased to a foreign person for periods aggregating more than 12 months out of any 24-month period.

i. Retirement-replacement-betterment (RRB) property

The Act repeals section 167(r), which permitted the use of the RRB method, as of January 1, 1981. Property placed in service after 1980 that would have been RRB property under prior law will be treated as 5-year property under ACRS. During a four-year transition period (1981–1984), a special transition rule is provided for such property that would have been expensed under RRB (replacements). Replacement property placed in service in 1981 will be expensed. Replacement property placed in service in 1982 through 1984 will be recovered over two, three, and four years, respectively, using an accelerated method prescribed in tables based on the 200-percent declining balance method with a switch to the sum of the years-digits method. Except for property placed in service in 1981, only one-half of a year's depreciation will be allowed for the year the property is placed in service, regardless of when during the year the property is placed in service.

The recovery percentages for such property during the four-year transition period are as follows:

Year placed in service	1981	1982	1983	1984
Ownership year:				
1	100	50	33	25
2		50	45	38
3			22	25
4				12

Replacement property placed in service in 1985 and later years is treated the same as other 5-year property under ACRS. Accordingly, replacement property placed in service in 1985 will be depreciated using the statutory method prescribed for property placed in service in 1985, which approximates the use of the 175-percent declining balance method with a switch to the sum of the years-digits method. For replacement property placed in service in 1986 and thereafter, the prescribed statutory method approximates use of the 200-percent declining balance method with a switch to the sum of the years-digits method.

The adjusted basis of RRB property that exists as of December 31, 1980 (the costs that were capitalized under the RRB method and had not been recovered through retirement) may be recovered over a period of not less than 5 years and not more than 50 years, using a method described in section 167(b), including the 200-percent declining balance method for the early years and switching to

the sum of the years-digits method at a time to maximize the accelertion of deductions. For example, a taxpayer may recover the so-called "frozen asset base" over a five-year period using the following schedule of deductions:

PERCENTAGE OF BASIS DEDUCTIBLE

Year:	*Percent*
1981	40
1982	24
1983	18
1984	12
1985	6

Under the Act, beginning in 1981, expenditures that are not capitalized (such as repairs) will not be allowed the investment credit. Under prior law, the investment credit was allowed for replacement-track material, regardless of whether such material might have been considered a repair. During the transition year 1981, expenditures that would have been capitalized if incurred in a later year are considered to have been capitalized, even though they are expensed under the transition recovery rule for 1981.

j. Tax preference for minimum tax and maximum tax

As under prior law, accelerated recovery on leased personal property is treated as an item of tax preference subject to the minimum tax. The amount of the tax preference for leased personal property is the amount by which the recovery deduction allowed exceeds the amount that would have been allowable if the deduction had been calculated using the half-year convention, no salvage value, and the straight-line method over an extended recovery period. The extended recovery period is five years for 3-year property, eight years for 5-year property, 15 years for 10-year property, and 22 years for 15-year public utility property. As under prior law, accelerated recovery on leased personal property is not an item of tax preference for corporations other than subchapter S corporations and personal holding companies.

For 15-year real property, the amount of the preference is the excess of the recovery deduction allowed over the deduction that would have been allowable if the deduction had been calculated using no salvage value and the straight-line method over the 15-year recovery period. This amount is a preference item for all taxpayers.[6]

For 1981, minimum tax preferences will continue to reduce the amount of personal service income subject to the 50-percent maximum tax. However, this preference offset is eliminated by the Act beginning after 1981 as a consequence of the reduction of the

[6] It was not the intent of the Congress that section 205(b) of the Act repeal the real property accelerated depreciation item of tax preference for corporations.

maximum tax rate on all income to 50 percent and repeal of the maximum tax rules applicable to earned income.

k. Regular investment credit

Eligibility

The regular investment tax credit applies to tangible personal property and other tangible property (generally not including buildings or structural components) used in connection with manufacturing, production, or certain other activities. Property used predominantly outside the United States generally is not eligible. The Act expands the categories of assets eligible for the investment credit to include certain previously excluded petroleum storage facilities and certain railroad rolling stock used within and without the United States.

Under prior law, petroleum products storage facilities generally were not considered personal property. Thus, petroleum products storage facilities (other than a building or a structural component) generally could qualify for the investment credit as other tangible property only if used in connection with manufacturing or production. Facilities used in connection with distribution generally did not qualify. In order to eliminate the distinction in treatment between petroleum products storage facilities used in connection with production and those used in distribution, the Act adds to eligible property facilities (other than buildings or their structural components) used for storage of petroleum and its primary products in connection with distribution of petroleum products. Under the Act, primary products of petroleum means the primary products of oil (but not gas) as defined under the DISC regulations (Treas. reg. § 1.993-3(g)(3)(i)).

Under prior law, there was an exception from the foreign use restriction permitting the credit for railroad rolling stock of a domestic railroad used within and without the United States. However, railroad rolling stock owned by a person other than a domestic railroad and used within and without the United States was not eligible. The Act adds to eligible property railroad rolling stock owned by a U.S. person other than a domestic railroad and used within and without the United States, and retains the prior law "within and without" exception for rolling stock of a domestic railroad. Railroad rolling stock of a U.S. person other than a domestic railroad is not eligible under the Act if it is leased on a long-term basis to a foreign person. Property is considered leased on a long-term basis if it is leased for periods aggregating more than 12 months out of a 24-month period.

Amount of credit

Under the Act, the investment credit initially allowable for recovery property is not based on the asset's actual useful life. Rather, the credit is based on the recovery class to which the property is assigned for determining cost recovery deductions under ACRS. For eligible property in the 5-year, 10-year, 15-year real property (e.g., elevators), or 15-year public utility property recovery class, the Act permits the full regular, ESOP, and energy credits (e.g., a 10-percent regular credit). For 3-year recovery property, only 60 percent of the investment qualifies for these credits

(e.g., a 6-percent regular credit), even if the taxpayer elects to use a longer recovery period under the section 168(b)(3) flexibility provisions.

The special limitations contained in section 46(c)(5) relating to amortization of pollution control facilities will continue to apply in lieu of the percentages specified for recovery property under new section 46(c)(7) because the credit percentages under prior law continue to apply to property that is not recovery property. Thus, the full credit will apply to pollution control facilities for which an election for five-year amortization is in effect if the useful life is at least five years. Also, the full credit will apply to commuter highway vehicles that are recovery property or that have a useful life of three years or more.

Used property limitation

The Act raises the used property limitation from $100,000 to $150,000 ($125,000 in taxable years beginning in 1981, 1982, 1983, or 1984) for property placed in service after 1980.[7]

Recapture of credit

Under the Act, the regular credit is recomputed upon early disposition of recovery property by allowing a two-percent credit for each year the property is held. Thus, no recapture is required for eligible 5-year, 10-year, or 15-year recovery property actually held for at least five years, or for eligible 3-year recovery property held for at least three years.

A similar rule applies to the energy credit. For example, assume the energy credit is 15 percent. The credit allowed is three percent for each year the property is held. If 5-year recovery property allowed the credit were disposed of during the fifth year, the recapture amount would be three percent.

Carryover of unused credit

The Act extends the carryover period for unused investment credits from seven years to 15 years. The carryback period remains three years as under prior law.

Noncorporate lessors

Under section 46(e), the investment credit is not allowed to noncorporate lessors for property leased under certain circumstances for a period exceeding 50 percent of the asset's useful life. For recovery property leased after June 25, 1981, section 46(e) is amended to require use of the ADR midpoint life of the property (in effect as of January 1, 1981) in determining whether the term of the lease is less than 50-percent of the useful life of the property. Thus, for leases subject to this new rule, the 50-percent of useful life test may not be applied by using the ADR upper limit life. The facts and circumstances test also may not be used in determining the useful life of the property, unless the Treasury has not prescribed an ADR midpoint life for the property.

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[7] In raising the used property limitation for the investment credit, the Congress intended that the effective date for the new limitations would be taxable years beginning after December 31, 1980.

For leases entered into before June 25, 1981, the 50-percent test may be applied under prior law rules by using the ADR upper limit life or a life based on all facts and circumstances.

l. Investment credit at-risk limitation

General rule

Under the Act, the allowance of investment credits is subject to a new at-risk limitation. The limitation applies to the same business activities and the same category of taxpayers that are subject to the loss limitation rules of section 465. Thus, the at-risk rules apply to individuals, subchapter S corporations, and certain closely held corporations that are engaged in business or income-producing activities, any losses from which would be subject to limitation under section 465.

In the case of a partnership, the investment credit at-risk rules do not apply to the partnership, but apply to each partner to whom the loss limitation rules of section 465 apply. Thus, the calculation of amounts at risk is made by each partner to whom the at-risk rules apply. Property placed in service by a partnership is considered to have been placed in service by the partners. Determinations of whether the taxpayer has acquired property or borrowed money from a related person are made with respect to each partner. In the case of a subchapter S corporation, the investment credit at-risk rules apply to both the subchapter S corporation and each of the shareholders to whom the loss limitation rules of section 465 apply. Calculations of amounts at risk are made by the corporation and each of the shareholders. Other determinations, such as the relation between a lender and the taxpayer, are made with respect to both the corporation and each of the shareholders.

The investment credit is not allowed for amounts invested in qualifying property to the extent the invested amounts are not at risk, within the meaning of section 465(b) (without regard to the rule in section 465(b)(5) that reduces amounts at risk by loss deductions allowed under section 465(a)). Accordingly, amounts generally are not considered at risk if (1) the taxpayer is protected against the loss of the invested amount, (2) the amount was borrowed and the taxpayer is not personally liable for repayment of the debt, (3) the lender has an interest other than as a creditor in the business activity in which the property is used, or (4) the lender is a related party to the taxpayer.

As discussed below, the Act contains two exceptions applicable where, under the general rule, amounts would be considered not at risk. The exceptions apply with respect to property financed by certain third-party lenders and certain energy property. These two exceptions apply only to amounts otherwise considered not at risk. Thus, under the first exception, certain amounts considered not at risk under the general rule are considered to be at risk. Under the second exception, certain amounts considered not at risk under the general rule and first exception are considered to be at risk. Therefore, an amount considered at risk under the general rule or either exception is considered to be at risk.

Exception for certain third-party loans

Under the first exception, amounts borrowed with respect to section 38 property (other than convertible debt) no later than the taxable year the property is placed in service generally will be considered at risk if the taxpayer at all times has a minimum 20-percent at-risk investment in the property (determined without regard to the exception) and the amount borrowed is owed to either a qualified lender or a Federal, State, or local government or instrumentality or is guaranteed by a Federal, State, or local government. The exception does not apply if the Federal, State, or local government or instrumentality is merely acting as a conduit with respect to the loan. Nor does the exception apply if the taxpayer has acquired the property from a related person.

Qualified lenders include banks, savings and loan institutions, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money. The lender must not be related to the taxpayer. In addition, the qualified lender may not be either a person who receives a fee with respect to the taxpayer's investment in the qualifying property (e.g., a promoter) or a person related to such person, nor may the qualified lender be the person who sells the qualifying property to the taxpayer or a person related to such person. As under prior law, the substance of a transaction, rather than its form, will determine whether it is characterized as a loan, a lease, or a sale, and thus, for example, whether a taxpayer has acquired property from the lender or has merely acquired financing from the lender. Banks, savings and loan institutions, credit unions, and insurance companies are considered related to the taxpayer, the promotor, or the seller, if they have more than a 10-percent equity investment in such person. Pension trusts and commercial lenders are considered related to the borrower, promoter, or seller if they have any equity interest in such person.

In order for debt to qualify under this exception, at no time during the first 12-month period of the debt may the lender transfer or have an agreement to transfer the debt to a nonqualified lender. After such 12-month period, a transfer of the debt or an agreement to transfer the debt to a nonqualified lender will not decrease the taxpayer's amount at-risk with respect to the property. The debt may not be secured by property of a party other than the taxpayer.

For purposes of applying the first exception, any debt of a partnership or subchapter S corporation incurred with respect to eligible property will be treated as the debt of the partners or shareholders and will be allocated among the partners or shareholders according to the rules for allocating the investment credit (Treas. Reg. § 1.46-3(f)). For example, an amount borrowed with respect to eligible property by a general partner on a recourse basis would be allocated among all the partners. A limited partner's share of such a borrowed amount would be considered, for purposes of the first exception, as an amount borrowed by the limited partner for which the limited partner has no personal liability to make repayment. Therefore, the limited partner would not be at risk for this amount under the general rule, but if the requirements of the first exception are otherwise satisfied by the limited partner, the limited

partner will be considered to be at risk with respect to his allocable share of the amount borrowed by the general partner. If the requirements of the first exception are not otherwise met by the limited partner, for example if the limited partner does not have a minimum 20-percent at-risk investment (determined under the general rule) in his share of the property, the first exception would not apply and the limited partner would not be considered to be at risk with respect to the amount borrowed by the general partner.

Exception for certain energy property

The Act also contains as safe harbor rule for loans related to qualified energy property. This special safe harbor rule applies only to solar or wind energy property, recycling equipment, qualified hydroelectric generating property, biomass property, equipment for converting alternate substances into alcohol fuels, geothermal equipment, and ocean thermal energy equipment, as those items are defined under section 48(l). The special safe harbor rule also applies to energy property that comprises a system for using the same energy source for the sequential generation of electrical power, mechanical shaft power, or both, in combination with steam, heat, or other forms of useful energy. This property includes, but is not limited to, cogeneration equipment (as defined in sec. 48(l)(14)) eligible for the energy credit. For property that is not cogeneration equipment, such as property used for the sequential generation of mechanical shaft power in combination with steam, heat, or other forms of useful energy, the safe harbor will apply only with respect to the regular credit since that property would not qualify for the energy credit.

This safe harbor rule is provided because, in normal commercial transactions, qualified energy property is often financed on a nonrecourse basis by the person who sells the property, i.e., the manufacturer or supplier of the property. Thus, although Congress has provided incentives for investment in new energy technologies, the investment credit at-risk rules would otherwise operate in such cases to make those incentives unavailable at the time the investment is made.

In order to qualify under the safe harbor, the taxpayer must have a minimum 25-percent at risk investment in the property as determined under the general rule. In addition, any nonrecourse financing for the property (other than financing by a qualified lender that is considered at risk) must be a level payment loan. A level payment loan is a loan repaid in substantially equal installments. The installments must include both principal and interest and the principal portion must increase commensurate with the decrease in the interest portion. Level payment loans are required because this type of loan is a normal form of commercial loan and timely payment on such a loan is an indication that the value of the property has not been overstated.

If a taxpayer does not make adequate principal payments on a nonrecourse loan to which this safe harbor applies, the credit will be recaptured as if the amount of the deficiency of principal payments had not been included in the cost of the property. In addition, interest will be added to the increase in tax as if the increase were for the taxable year the property was placed in service. This

recapture rule will not apply until the second taxable year following the taxable year the property was placed in service. Whether principal payments are adequate is determined by reference to the schedule of principal payments that would be made under a level payment loan that is fully repaid by the end of the present class life of the property or, if earlier, the end of the term of the loan.

Under a special rule, if the taxpayer's cumulative deficiency in making principal payments becomes equal to or greater than the total principal payments that would have been made under a level payment loan for the most recent five-year period, the entire amount of the credit will be recaptured (to the extent not previously recaptured). Thus, if the actual principal payments are not consistent with a level payment loan, there would be some concern that the property had been overvalued and recapture of the investment credit would be appropriate.

These special recapture rules apply only to amounts borrowed on a nonrecourse basis that are not treated as amounts at risk under the first exception for certain third-party lenders. Thus, borrowed amounts that are treated as amounts at risk under the first exception (sec. 46(c) (8) (B) (ii)) are subject to the regular rules, described below, that apply to reductions in amounts at risk.

Amounts at risk

Amounts at risk for qualifying property are only those amounts considered at risk under section 46(c)(8)(B) that are directly attributable to investment in the property. Cash contributed to the operating expenses of a business is not considered at risk for section 38 property used in the business. Similarly, a loan for the operation of a business, even if recourse, would not be considered at risk with respect to section 38 property.

A taxpayer's amount at risk for property is increased only through increases in the actual investment in the property, such as by repayment of nonrecourse debt for the property. Repayment must be made with amounts for which the taxpayer is at risk within the meaning of section 46(c)(8)(B). Repayment of debt from a qualified lender, which is considered to be at risk, will not increase the taxpayer's amount at risk for property. Operating profits of a business increase the amount at risk in the business for purposes of section 465. However such amounts are not considered at risk for qualifying property unless used either to invest in qualifying property or to repay amounts borrowed for qualifying property. If the amount at risk for property is increased, the credit for the property is redetermined as if the increased amount at risk had been taken into account when the property was first placed in service. Any increase in the credit attributable to the increased amount at risk is considered a credit earned in the taxable year the amount at risk was increased.

Amounts at risk with respect to property are reduced only if the taxpayer's investment in the property decreases. Cash distributions generally will not reduce a taxpayer's amount at risk with respect to property. ACRS deductions will not reduce a taxpayer's amount at risk for property. Amounts at risk with respect to section 38 property will be reduced when recourse debt is converted into

nonrecourse debt or when qualified debt is refinanced by the taxpayer and is replaced by debt for which the taxpayer is not at risk.

Congress intended that certain issues relating to the investment credit at-risk rules would be clarified in regulations. For example, it is intended that a taxpayer who makes an at-risk investment in one item of property and a non-at-risk investment in a second item of property should be allowed an investment credit to the extent of the at-risk investment in the first item. However, it is unclear which item of property would be eligible for the credit if the taxpayer had purchased the first item for cash and had purchased the second item with the proceeds of a nonrecourse loan secured by the first item. Other issues to be clarified in regulations relate to changes in ownership interests of partnerships and subchapter S corporations and the treatment of business receipts other than taxable income.

When an amount at risk with respect to property is reduced, the credit for the property is redetermined as if only the reduced amount at risk had been taken into account when the property was first placed in service. Any credit previously earned in excess of the redetermined credit increases the taxpayer's tax liability for the taxable year the amount at risk is reduced. This rule applies to all taxable years following the taxable year the property is placed in service.

The investment credit recapture rules generally will govern recapture upon the disposition (or cessation as qualifying property) of section 38 property. A special recapture rule applies to dispositions of property that are subject to the special rules for certain energy property. Under the special rule, the credit recapture amount is the amount of unpaid principal on the level payment loan as of the date of disposition. Any amount of the loan that is assumed or taken subject to will not be treated as reducing the unpaid principal with respect to the loan.

The Act provides that the at-risk limitation on the investment credit will not apply to property placed in service before February 19, 1981, or property placed in service on or after such date if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981. For purposes of this rule, the Treasury shall prescribe regulations under which property will be considered to have been acquired under a binding contract if it was acquired in a manner that would have qualified the property as pretermination property under section 49(b) (as in effect before its repeal by the Revenue Act of 1978).

m. Qualified progress expenditures

The Act repeals the requirement that progress expenditure property have a seven-year useful life. For recovery property, the amount of credit allowed with respect to progress expenditures is based on the recovery class the taxpayer expects the property to be in when the property is placed in service. For example, a full ten-percent credit will be allowed for progress expenditure property the taxpayer anticipates will be in the 5-year recovery class when the property is placed in service.

The Act retains the prior law rules used to determine the amount and timing of qualified progress expenditures.

n. Normalization requirement for public utility property

Under prior law, a public utility could use an accelerated depreciation method only if it also used a normalization method of accounting, unless the company used flow-through accounting for accelerated depreciation in 1969. A public utility that had to normalize accelerated depreciation could use the ADR system only if it normalized certain differences between the ADR useful life and the ratemaking useful life of eligible property. Similarly, a utility that had to normalize accelerated depreciation also had to normalize the investment tax credit. In addition, some utilities not required to normalize accelerated depreciation were required to normalize all or part of the investment credit.

Under the Act, except as provided in relevant transition rules, public utility property placed in service after December 31, 1980, is eligible for the investment credit and accelerated cost recovery under ACRS only if all the tax benefits of the investment credit and ACRS are normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.

If a normalization method of accounting for ACRS benefits is not used with respect to property placed in service after December 31, 1980, such property will not be eligible for the investment credit and will not be treated as recovery property. However, such property would not be subject to the depreciation rules applicable to property placed in service before 1981. Thus, accelerated depreciation methods permitted under prior law section 167 generally could not be used and useful lives based on facts and circumstances or the ADR system could not be used. Instead, the Act provides that a depreciation allowance for such property would be determined under section 167(a), using a depreciation method the same as, and a useful life no shorter than, the depreciation method and useful life used to compute the depreciation allowance for the property for purposes of setting rates and reflecting operating results in regulated books of account. For this purpose, averaging conventions and salvage value limitations are considered part of the ratemaking depreciation method.

Under the Act, the benefits of ACRS that must be normalized include those attributable to the prescribed ACRS accelerated depreciation schedules, the ACRS recovery periods, the ACRS averaging conventions, and the ACRS salvage value rules. Therefore, ratemaking depreciation methods, useful lives, placed in service rules, and salvage value rules will be used in determining the amount of deferred taxes that result from using ACRS.

As under prior law, the Act does not restrict the authority of regulatory bodies to treat the deferred taxes as zero-cost capital or as a reduction in rate base in setting rates. However, as under prior law, the amount of capital treated as zero-cost capital and the amount of rate base reduction may not exceed the amount of deferred taxes that result from the taxpayer's use of the recovery periods and methods actually used to compute a recovery allowance.

The Act does not provide for any flowthrough accounting for property placed in service after December 31, 1980. Thus, public utility property placed in service after December 31, 1980, that is

the same type of property as pre-1981 property for which flow-through accounting is permitted is subject to the normalization requirement.

The Act also provides, subject to a special transition rule, that the benefits of the investment credit must be normalized for all public utility property placed in service after December 31, 1980.

Under transition rules, taxpayers are considered to satisfy the new normalization requirements for depreciation or the investment credit with respect to a rate order that complies with the requirements of prior law if (1) the rate order was put into effect before the date of enactment of the Act and (2) a superseding rate order determining cost of service is put into effect complying with the new applicable normalization requirements before January 1, 1983.

o. Leasing

Background

The benefits of depreciation deductions and investment credits attributable to property generally are available only to the owner of the property. In many cases, companies in a tax loss position and thus unable to use currently the tax benefits of owning equipment have been able to obtain a portion of those benefits indirectly by leasing the equipment from companies having sufficient taxable income to use the tax benefits. The use of the tax benefits by the leasing company was reflected in reduced rental payments charged to the loss company. The determination of whether these "lease financing" transactions should be treated for tax purposes in accordance with their form as leases or whether they should be recharacterized as in substance conditional sales or financing arrangements required a case-by-case analysis.

If a transfer of property were treated as a lease, reasonable rental payments by the lessee would be deductible by a lessee using the property in a trade or business. Also, since ownership under a lease remains with the lessor, the lessor would be entitled to recover its costs through depreciation and investment tax credits. The rental payments received by the lessor would be taxable at ordinary income rates.

On the other hand, if the transfer were a financing arrangement or conditional sale by the nominal lessor rather than a lease, the transferee of the property would not be able to deduct its payments as rent. The lessee could claim depreciation and investment tax credits since it would be treated as the owner of the property by virtue of the sale. For a lessee that is unable to utilize the tax benefits, the cost of acquiring the equipment would be higher than if the lessor took the benefits and passed them through to the lessee in the form of lower rents. For the lessor, no depreciation or investment credit would be allowed. Any difference between the lessor's basis in the property and the amount received from the lessee would be treated as gain from the sale of the property. Assuming the asset is a capital asset and has been held for more than 1 year, the gain would generally be capital gain (except for the portion treated as imputed interest under section 483, which is taxable at ordinary income rates). Installment reporting of the gain may be available to the seller.

For purposes of obtaining an advance letter ruling, the Internal Revenue Service in a series of Revenue Procedures (Rev. Procs. 75–21, 75–28, and 76–30) has established guidelines for determining whether a transaction is a lease or merely a financing arrangement by the nominal lessor.

Included among the requirements for a transaction to be a true lease under the IRS guidelines are the following:

1. The lessor must have a 20-percent minimum at risk investment in the property throughout the lease term;
2. The lessor must have a positive cash flow and a profit from the lease independent of tax benefits;
3. The lessee must not have a right to purchase the property at less than fair market value;
4. The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner; and
5. The use of the property at the end of the term of the lease by a person other than the lessee must be commercially feasible.

Reasons for change

Under the prior law depreciation rules, many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions. Deductions that could not be used in a taxable year generated a net operating loss, which had to be carried back three years and forward seven years. Since, in most instances, the deductions permitted under the Accelerated Cost Recovery System (ACRS) are more accelerated than those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that previously were marginally profitable for tax purposes could be thrown into a loss position.

Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies still will be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. The safe-harbor leasing provisions under the Act are designed to address this issue.

Explanation of provision

Overview of safe harbor provisions

The Act provides a safe harbor that guarantees a transaction will be treated as a lease, rather than a financing arrangement, even though the transaction does not comply with the Internal Revenue Service guidelines for obtaining an advance letter ruling, and even though the transaction would not otherwise be a lease. To be eligible for the safe harbor, the following requirements must be met:

1. All parties to the agreement must elect;
2. The nominal lessor must be (a) a corporation (other than a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which are one of those corporations, or (c) a grantor trust with respect to which the grantor and

all beneficiaries of the trust are corporations or a partnership comprised of corporations;

3. The lessor must have a minimum at-risk investment in the porperty at all times during the lease term of at least ten percent of the adjusted basis of the property;

4. The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and

5. The property must be "qualified leased property."

Factors disregarded

If a transaction meets the safe harbor requirements, the transaction will be treated as a lease entered into by the parties to the agreement and the nominal lessor will be treated as the owner for Federal tax purposes. Thus, the nominal lessor will be entitled to the associated cost recovery allowances and investment credit. The following factors will therefore not be taken into account in determining whether a transaction is a lease:

1. The fact the lessor or lessee must take the tax benefits into account in order to realize a profit or cash flow from the transaction;

2. The fact the lessee is the owner of the property for State or local law purposes (e.g., has title to the property and retains the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);

3. The fact that no person other than the lessee may be able to use the property after the lease term;

4. The fact the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment is made upward or downard to reflect the difference between the expected residual value of the property and the actual sales price; and

5. The fact the lessee, or a related party, has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment).

The new provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resemblance to a lease.

For example, assume corporation X acquires 5-year recovery property with a 10-year economic life worth $1 million, but cannot use the tax benefits. X and corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for State law purposes. Y will then lease back the property to X for nine years at which time

there will be a paper transfer of the property back to X for $1. Y agrees to pay X $200,000 in cash and to give X a note for $800,000 plus interest at the market rate. In return, X agrees to pay rent in an amount exactly equal to Y's $800,000 obligation plus interest.

Looking at the substance of the transaction between X and Y, which is cast in the form of a sale-leaseback, there has been no change of ownership and there is no business purpose for the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction excluding tax benefits. However, since the transaction is treated as a sale to Y and leaseback to X under the safe harbor provisions, the Federal income tax law will recognize the form of the transaction producing the following economic consequences.

For Y, the present value of the tax savings due to cost recovery allowances, ITC, and interest deductions will exceed the present value of the tax on the rental income producing a return on Y's initial investment solely from tax savings. For X, the transaction results in a reduction of cost of $200,000, which is the amount of the up-front cash payment by Y.

Minimum at-risk investment

In general, the requirement that a lessor maintain a ten-percent minimum at-risk investment in the property throughout the lease term means that the lessor must have an equity investment in the property. For this purpose, an equity investment includes only consideration paid and personal liability incurred by the lessor to purchase the property other than debt to the lessee or a person related to the lessee. Contrary to the Internal Revenue Service guidelines discussed above, the minimum investment rule is determined with respect to the adjusted basis of the property rather than its original basis.

Qualified leased property

"Qualified leased property" means recovery property (other than a "rehabilitated building") which meets one of three requirements. First, "qualified leased property" includes new section 38 property (i.e., property eligible for the investment tax credit) of the lessor which is leased within three months after the property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee. The original use of the property must commence with the lessor to be new section 38 property of the lessor. The lessor may use the property within the three-month period prior to the lease.

Second, with respect to a sale-leaseback transaction, "qualified leased property" includes property that was new section 38 property when acquired by the lessee. The sale to the nominal lessor and the leaseback to the lessee (the original user) must occur within three months after the property was placed in service by the lessee, and the adjusted basis of the lessor must not exceed the adjusted basis of the lessee at the time of the lease.

For new section 38 property placed in service after December 31, 1980, and before the date of enactment of the Act (August 13, 1981), property will be considered to have met the requirement that the property be leased within three months of the date the property

was placed in service if the property was leased by November 13, 1981.

Third, qualified leased property includes qualified mass commuting vehicles (as defined in section 103(b)(9), as added by the Act) financed in whole or in part by obligations the interest on which is excludable from income under section 103(a). Mass commuting vehicles qualify even though the property is used by a tax-exempt organization or governmental unit in an exempt function and, thus, does not qualify for the investment credit. However, only cost recovery allowances attributable to qualified mass commuting vehicles, and not investment credit, may be transferred under a safe harbor lease.

Since, except for the special rule for mass commuting vehicles, qualified leased property must be new section 38 property, the safe harbor rule will not apply, for example, for that portion of any property used by the lessee for personal purposes, used by a governmental unit, or used by a tax-exempt organization (other than in an unrelated trade or business).

Amount and timing of deductions and credits

The Act also gives the Treasury authority to prescribe regulations necessary to carry out the purposes of the safe harbor, including (but not limited to) regulations consistent with those purposes that limit the amount and timing of deductions to the amount allowable without regard to the safe harbor rules. The Statement of Managers indicates that the conferees intended the amount and timing of cost recovery allowances in the hands of the lessor to be the same as they would have been in the hands of the lessee.

Qualified leased property used during the three-month period prior to the lease will be considered first placed in service at the time of the lease for purposes of determining when and by whom the cost recovery allowances and investment credits are taken. For a sale-leaseback, this rule prevents both the lessor and the lessee from claiming the tax benefits for the property. This rule does not apply for determining whether property is qualified leased property. As noted previously, to qualify under section 168(f)(8)(D)(i) or (ii), the property must be new section 38 property when acquired by the lessor or when acquired by the lessee in a sale-leaseback. However for determining the amount of the credit, qualified leased property will be treated as new property. Thus, the fact that in a sale-leaseback new property is used by the lessee within a 3-month period prior to the sale-leaseback will not prevent the lessor from claiming the credit for new property. Also, the period for determining recapture of credit will begin on the first date the property is used under the lease.

The legislative history suggests that a lessor's basis in the leased property includes the entire amount of any obligation with respect to the property even if the obligation of the lessor is contingent or offset by rental payments. This rule, which overrides prior case law, eliminates the necessity of the parties actually making the offsetting payments to ensure the tax consequences of basis, income, and deductions that would have occured if the payment had been made. However, Congress intended that the Treasury Department prescribe regulations to ensure that the lessor reports

as income all rental payments due, even if not actually received because of the offset agreement. In addition, the Treasury shall prescribe regulations requiring the lessor to report the rental income on a ratable basis eliminating deferral of income to the lessor that would result by virtue of, for example, a balloon payment agreement. With respect to interest deductions, calculations under a level payment mortgage assumption will be permitted.

Recapture rules

If the lessee acquires the property from the lessor at the end of the lease and subsequently disposes of it, the lessee will be subject to the recapture rules under sections 47 and 1245 as if the lessee had been considered the owner of the property for the entire term of the lease, except that any amount recaptured by the lessor will not be recaptured again by the lessee. For example, assume the lessor claimed $100 of cost recovery allowances for 5-year recovery property over the lease term and has a zero adjusted basis in the property at the end of the lease. The lessor sells the property to the lessee for $1.00. The lessee subsequently sells the property to a third party for $80. The lessor would have a $1 gain on the sale to the lessee, all of which would be treated as ordinary income under the section 1245 recapture rules. The lessee would have $79 gain ($80 sales price—$1 cost basis) all of which would be treated as ordinary income under the section 1245 recapture rules.

Effective Dates and "Anti-Churning" Rules

Effective dates

In general, the capital cost recovery and investment credit provisions apply to property placed in service after December 31, 1980. The most accelerated method of cost recovery for personal property is not available until 1986. As under prior law, property is considered placed in service when it is placed in a condition of readiness for a specifically assigned function, whether in the taxpayer's trade or business or the production of income, in a tax-exempt activity, or in a personal activity. Thus, ACRS is not allowed for a house used prior to 1981 by a taxpayer as a personal residence even though it is converted to rental use after 1980.

ACRS applies to property placed in service during 1981 even though the taxpayer's taxable year ended prior to enactment. ACRS also applies to post-1980 capital improvements made to real or personal property placed in service prior to 1981.

The provision relating to railroad rolling stock of a U.S. person other than a domestic railroad applies to taxable years beginning after December 31, 1980.

The rules for extension of the carryover period for net operating losses (NOL's) generally apply for NOL's in taxable years ending after December 31, 1975. This effective date was chosen to ensure that the provision applied to the oldest unexpired carryovers. NOL's incurred in taxable years ending before January 1, 1976, had only a 5-year carryover period and thus would have expired by 1981. The rule extending the NOL carryover period also applies to any NOL deduction taken by a real estate investment trust ("REIT") in taxable years ending after October 4, 1976, with re-

spect to NOL's incurred in taxable years ending after 1972. However, for NOL's of a former REIT, the extension applies only with respect to NOL's incurred in taxable years ending after 1975.[8]

The effective dates for extension of the carryover periods for various credits are as follows:

(1) Investment credit and WIN credits.—Taxable years in which an unused credit arises (unused credit years) and which end after December 31, 1973.

(2) New employee credit.—Unused credit years ending after December 31, 1976.

(3) Alcohol fuels credit.—Unused credit years ending after September 30, 1980.

The at-risk rule for the investment credit applies to property placed in service on or after February 19, 1981, except for property acquired by the taxpayer pursuant to a binding contract entered into on or before February 18, 1981. The technical amendment to section 46(e) relating to investment credit for noncorporate lessors applies to leases entered into after June 25, 1981.

Anti-churning rules

Special rules are provided to prevent the taxpayer from bringing its property owned or used during 1980 under ACRS by certain post-1980 transactions (i.e., "churning" transactions). Similar rules are provided to prevent the taxpayer from taking advantage of the increased recovery percentages available after 1984 for its property used before 1985.

Two sets of anti-churning rules are provided. One set of rules applies to "section 1245 class property" and the other set of rules applies to "section 1250 class property." Section 1250 class property includes (1) all real property, as that term has been used in this explanation of ACRS, and (2) property in the 10-year recovery class that is described in section 1250(c), i.e., residential manufactured homes and real property described in section 1250(c) with an ADR midpoint life of 12.5 years or less as in effect on January 1, 1981. Section 1245 class property includes all personal property, as that term has been used here, except the 10-year class property mentioned above.

For section 1245 class property, ACRS will not apply (and thus prior law rules of depreciation will apply) if (1) the property was owned or used by the taxpayer or a related person during 1980, (2) the property was acquired from any person who owned the property during 1980, unless the user of the property also changes as part of the transaction, (3) the property was leased back to a person that owned or used the property during 1980 or to a related person, or (4) the property transferred is not recovery property in the hands of the transferor by reason of the application of the anti-churning rules under (1) or (2) above, unless the user of the property changes as part of the transaction. The Treasury shall prescribe regulations for determining whether the user of property changes as part of a transaction.

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[8] A provision in the Conference Agreement inadvertently reduced to five years the carryover period for NOL's incurred by a former REIT in 1973, 1974, or 1975. The Concurrent Resolution restored the carryover period to eight years.

ACRS will not apply to section 1250 class property if (1) the taxpayer or a person related to the taxpayer owned the property during 1980, (2) the property is leased back to a person that owned the property at any time during 1980 or to a person related to that person or (3) the property is acquired for property of the taxpayer or a related person owned during 1980 in certain like kind exchanges, "rollovers" of low-income housing, involuntary conversions, or repossessions. The sale-leaseback restriction in (2) is generally intended to apply only with respect to that portion of the building (determined on a fair market value basis) that is leased by the prior owner or the person related to the prior owner. The restriction in (3) applies only to extent the basis of the property includes an amount representing the adjusted basis of the property given up in the exchange or other property owned by the taxpayer or a related person.

For either section 1245 class property or section 1250 class property placed in service by the transferor or distributor before January 1, 1981, which was acquired by the taxpayer in a nonrecognition transaction (specifically, transactions described in sections 332, 351, 361, 371(a), 374(a), 721, or 731), ACRS will not apply to the extent the basis of the property is determined by reference to the basis of the property in the hands of the transferor or distributor. In that case, the Treasury shall provide rules similar to those that apply under section 381(c)(6).

To make clear that property (1) owned by the taxpayer and under construction during 1980, and (2) placed in service by the taxpayer after December 31, 1980, is not subject to the anti-churning rules, the property is not treated as owned until it is placed in service.

For the anti-churning rules, a person is related to another person if (1) the related person bears a relationship to that person specified in sections 267(b)(1) or 707(b)(1) by substituting 10 percent for 50 percent or (2) the related person and that person are engaged in trades or businesses under common control within the meaning of sections 52(a) and (b). The determination of whether a party is related to another person is made at the time of acquisition of the property. A corporation is not considered a person related to the taxpayer if (1) the corporation was a distributing corporation in a complete liquidation to which section 334(b)(2)(B) applies, and (2) stock of the distributing corporation referred to in that section (generally 80 percent of all voting stock and 80 percent of all other classes of stock other than nonvoting stock limited and preferred as to dividends) is acquired by the taxpayer by purchase (within the meaning of section 334(b)(3)) after December 31, 1980, and during the 12-month period described in section 334(b)(2)(B). A similar rule applies for partial or complete liquidations described in section 331(a)(1) or (2) if the taxpayer by himself or together with one or more other persons acquires stock of the distributing corporation referred to in section 334(b)(2)(B) by purchase (within the meaning of section 334(b)(3)) after December 31, 1980, and during the 12-month period described in section 334(b)(2)(B).

Revenue Effect

The ACRS provisions described in this section II–A of the General Explanation, other than the increase in the used property limitation for the investment tax credit, are estimated to reduce fiscal year budget receipts by $1,503 million in 1981, $9,569 million in 1982, $16,796 million in 1983, $26,250 million in 1984, $37,285 million in 1985, and $52,797 million in 1986.

The provision (sec. 213 of the Act) increasing the dollar limitation on used property eligible for the investment tax credit is estimated to reduce fiscal year budget receipts by $24 million in 1981, $61 million in 1982, $74 million in 1983, $85 million in 1984, $137 million in 1985, and $198 million in 1986.

B. Rehabilitation Expenditures

(Secs. 212 and 214 of the Act and sec. 48(g) of the Code)*

Prior Law

Investment tax credit

Overview

Buildings and their structural components (other than elevators and escalators) generally do not qualify for the investment tax credit. However, in 1978 the Congress extended the investment credit to rehabilitation expenditures for nonresidential buildings that were at least 20 years old. Residential buildings generally did not qualify for the investment credit.

A rehabilitation qualified under prior law only if at least 20 years had elapsed since the last qualifying rehabilitation. In addition, at least 75 percent of the existing external walls had to be retained as external walls after rehabilitation. The rehabilitation expenditures had to be made for property with a useful life of five years or more. No credit was allowed for any expenditure attributable to enlargement of the building.

Rehabilitation expenditures qualifying for the investment credit were treated as new property. Therefore, the expenditures were not subject to the $100,000 used property credit limitation under prior law.

Historic structures

If the rehabilitated building was a certified historic structure the rehabilitation had to be approved by the Secretary of the Interior before the investment credit was available. A certified historic structure was defined as a building or structure that was (1) listed in the National Register of Historic Places or (2) located in a registered historic district and certified by the Secretary of the Interior as significant to the district.

Depreciation

In addition to the investment credit, and in some cases in lieu of the credit, several special depreciation benefits were available to specified types of rehabilitated buildings. These special depreciation benefits and their relation to the investment credit are summarized by the following table.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 212; S. Rep. No. 97-144 (July 6, 1981), pp. 69-74; Senate floor amendments, 127 Cong. Rec. S8344-45 and S8620 (daily ed. July 23, 1981 and July 28, 1981); H.R. 4242, as reported by the House Ways and Means Committee, secs. 221, 222; H. Rep. No. 97-201 (July 24, 1981), pp. 93-98; H.R. 4242, as passed by the House (July 29, 1981), sec. 212; and H. Rep. No. 97-215 (August 1, 1981), pp. 221-222 (Joint Explanatory Statement of the Committee of Conference).

Capital Cost Recovery for Rehabilitation Expenditures Under Prior Law

Type of property	Depreciation options	Limitations and relation to investment tax credit
Residental real property [1]		
(a) Certified historic structures	1. Elect to amortize costs of certified rehabilitation over a 60-month period (sec. 191).	
	2. Elect to use 200-percent declining balance depreciation for the cost basis attributable to both the rehabilitated and nonrehabilitated portions of the building (sec. 167(o)).	200-percent declining balance method unavailable if amortization under section 191 was ever elected by the taxpayer for the same structure.
(b) Low-income housing	Elect to amortize cost of rehabilitation expenditures over a 60-month period (sec. 167(k)).	Limited to $20,000 of cost per residential unit.
(c) Other depreciable residential property.	No special depreciation benefit.	
Nonresidential real property		
(a) Certified historic structures	1. Elect to amortize cost of rehabilitation over a 60-month period (sec. 191).	No investment credit for amortized expenditures.
	2. Elect to use 150-percent declining balance depreciation for the cost basis attributable to both the rehabilitated and nonrehabilitated portions of the building (sec. 167(o)).	150-percent declining balance method unavailable if amortization under section 191 was ever elected by the taxpayer for the same structure. Investment credit (sec. 48(g)) may be claimed in addition to 150-percent declining balance method.
(b) Other nonresidential property	No special depreciation benefit.	10-percent investment tax credit (sec. 48(g)).

[1] Under prior law, the investment tax credit generally was unavailable for residential property.

Demolition of historic structures

Under prior law, a building constructed or reconstructed on the site of a demolished or substantially altered certified historic structure had to be depreciated using the straight-line method over its useful life (sec. 167(n)). The cost of demolishing a certified historic structure could not be deducted, but rather had to be capitalized as part of the basis of the land on which the structure was located (sec. 280B).

Reasons for Change

The Congress believed that tax incentives for capital formation provided in other sections of this Act could have had the unintended and undesirable effect of reducing the relative attractiveness of the incentives under prior law to rehabilitate and modernize older depreciable structures. Investments in new structures and new locations do not necessarily promote economic recovery if they are at the expense of older structures, neighborhoods, and regions. A new structure with new equipment may add little to capital formation or productivity if it simply replaces an existing plant in an older structure in which the new equipment could have been installed. Furthermore, the relocation of a business can result in substantial hardship for individuals and communities. Since this hardship does not affect the profitability of the business, it may not have been fully taken into account in the decision to relocate, even though it is an economic detriment to the society as a whole.

Accordingly, the increased credit for rehabilitation expenditures is intended to help revitalize the economic prospects of older locations and prevent the decay and deterioration of distressed economic areas.

Explanation of Provisions

Overview

Three-tier credit

Under the Act, the ten percent regular investment credit (and the additional energy credit) is replaced by a three-tier investment credit for qualified rehabilitation expenditures. The credit is 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures. In general, no credit is allowed for rehabilitation of a building less than 30 years old.

Under the Act, the provision (sec. 191) permitting 60-month amortization of rehabilitation costs for certified historic structures in lieu of the credit is repealed. No regular investment credit or energy investment credit is allowed for qualified rehabilitation expenditures.

The 15- and 20-percent credits are limited, as under prior law, to nonresidential buildings. However, the 25-percent credit for a certified rehabilitation of a certified historic structure is available for both nonresidential and residential depreciable buildings.

These credits are available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures. As discussed above in connection with the ACRS

treatment of real property, a taxpayer may elect accelerated cost recovery percentages for the building shell and straight-line for the rehabilitated portion only if the rehabilitation constitutes a substantial improvement that is treated as a separate building for purposes of electing recovery periods and methods under section 168(f)(1)(C).

Although no certain period of time must elapse between qualifying rehabilitations as under prior law, a rehabilitation qualifies only if the building has been substantially rehabilitated.

The investment credit at-risk rules under new section 46(c)(8) do not apply to the rehabilitation tax credit since those rules do not apply to property used in a real estate activity (secs. 46(c)(8)(A)(ii) and 465(c)(3)(D)).

Retention of certain rules

As under prior law, certain expenditures do not qualify for the credit. The costs of acquiring a building or an interest in a building (such as a leasehold interest) or the costs of facilities related to an existing building (such as a parking lot) will not be considered qualified rehabilitation expenditures. In addition, the cost of constructing a new building, or of completing a new building after it has been placed in service, does not qualify. Construction costs are considered to be for new construction rather than for the rehabilitation of a building if more than 25 percent of the external walls in existence before the beginning of the rehabilitation of the building are replaced. In addition, any expenditure attributable to enlargement of a building does not qualify for a credit.

Recapture, basis reduction rules

The investment credit recapture rules applicable to the regular, ESOP, and energy credits apply to the rehabilitation credit. For example, if a certified historic structure were disposed of in the fourth year after the rehabilitated portion of the building was placed in service, the 25-percent rehabilitation credit would be reduced to 15 percent, requiring recapture of 10 percentage points of the credit. No recapture is required after five years.

For rehabilitation credits other than the credit for certified rehabilitations of certified historic structures, the basis of the property must be reduced by the amount of the credit allowed. If subsequently there is a recapture of the credit, the resulting increase in tax (or adjustment in carrybacks and carryovers) will increase the basis of the building immediately before the recapture event for purposes of computing gain or loss.

Qualified rehabilitation expenditures

Expenditures are qualified rehabilitation expenditures only if they are properly chargeable to capital account, incurred after December 31, 1981, and made for real property with a 15-year recovery period under section 168. In addition, the rehabilitation must be substantial. A building has been substantially rehabilitated if either of two conditions are met.

First, a building has been substantially rehabilitated if the qualified rehabilitation expenditures during the 24-month period ending on the last day of the taxable year exceed the greater of (a) the

adjusted basis of the building (but not the land) as of the first day of the 24-month period, or (b) $5,000.

Second, a building has been substantially rehabilitated if it meets the requirements under the first alternative by substituting 60 months for 24 months. However, under regulations prescribed by the Treasury Department, this 60-month alternative will be available only if the rehabilitation is reasonably expected to be completed in phases set forth in architectural plans and specifications.

Certified historic structures

A certified historic structure is defined as a building (and its structural components) listed in the National Register of Historic Places or a building that is located in a registered historic district and certified by the Secretary of the Interior to be significant to the district. A registered historic district includes historic districts listed in the National Register and districts designated under State and local law, which laws and designations are approved by the Secretary of the Interior. These definitions are generally the same as under prior law section 191. However, under prior law a certified historic structure might include some types of real property other than a building, but under the Act a certified historic structure includes only buildings and their structural components.

The 15- and 20-percent credits are not allowed for a certified historic structure. In addition, for a rehabilitation of a building in a registered historic district that has not been designated a certified historic structure, neither the 15- nor the 20-percent credit is available unless the taxpayer obtains a certificate from the Secretary of the Interior that the building is not of historic significance to the district. This is in contrast with the prior law rule that allowed the 10-percent rehabilitation credit for such a building without requiring the taxpayer to obtain that certificate.

Property leased to exempt organizations or governmental units

The prior law rule denying investment credit for property leased to tax-exempt organizations (sec. 48(a)(4)) or governmental units (sec. 48(a)(5)) does not apply to the portion of the basis of a qualified rehabilitated building attributable to qualified rehabilitation expenditures. This provision in the Act corrects a clerical error in the enrollment of the Miscellaneous Revenue Act of 1980, as a result of which this rule was omitted from the 1980 statute.

Demolition of certified historic structures

The Act repeals the prior law rule (sec. 167(n)) requiring the use of straight-line depreciation for a building located at the site of a demolished or substantially altered certified historic structure. However, the Act retains the prior law rule (sec. 280B) requiring capitalization of demolition costs of (1) a certified historic structure and (2) a building in a registered historic district, unless the taxpayer obtains a certificate that the building is not of historic significance to the district.

Lessees

If a rehabilitation is undertaken by a lessee, the Act provides that the lessee is eligible for the investment credit for qualified rehabilitation expenditures incurred by the lessee, but only if, on the date of completion of the rehabilitation, the remaining term of the lease is at least 15 years.

The Treasury will prescribe rules for applying the substantial rehabilitation requirement to lessees.

Effective Date

The rehabilitation provisions generally apply to expenditures incurred after December 31, 1981, in taxable years ending after that date.

However, the Congress intended that the prior law 10-percent investment credit and 60-month amortization provisions continue to apply to a rehabilitation if (1) physical work on the rehabilitation began before January 1, 1982, and (2) the rehabilitation does not satisfy the requirements of the new law, but does satisfy the requirements of prior law section 48(g)(1).[1] Such a failure to satisfy the requirements of the new law could occur, for example, if rehabilitation expenditures incurred after December 31, 1981, do not satisfy the test of the new law for a substantial rehabilitation. In the case of a taxpayer electing 60-month amortization pursuant to this rule, the previously enacted December 31, 1983 expiration date for that provision will apply to amortizable rehabilitation expenditures.

If expenditures for a rehabilitation qualifying under the new law are incurred both before 1982 and after 1981, the post-1981 expenditures will be eligible for the new three-tier credit. The pre-1982 expenditures will be eligible to qualify for either the 10-percent credit or 60-month amortization. In other words, there may be a combination of old and new law applying to a single rehabilitation when the expenditures occur on both sides of January 1, 1982. For that combination, if the 60-month amortization is elected for a portion of the expenditures, the rule contained in Treasury Regulations § 1.191-2(e)(8) including in amortizable basis only those expenditures attributable to components of the building completed before expiration of the provision will not apply. Rather, the Congress intended that, in this one case, all otherwise qualified rehabilitation expenditures incurred before January 1, 1982 (whether or not for a component completed before the new December 31, 1981, expiration date) be included in amortizable basis.

Revenue Effect

The provisions relating to rehabilitation expenditures are estimated to reduce fiscal year budget receipts by $9 million in 1981, $129 million in 1982, $208 million in 1983, $240 million in 1984, $304 million in 1985, and $414 million in 1986.

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[1] The Congress intended that 60-month amortization is to be available for a rehabilitation that meets the requirements of prior law section 191 but not prior law section 48(g)(1).

C. Incentives for Research and Experimentation

1. Credit for increasing research activities (sec. 221 of the Act and new sec. 44F of the Code)*

Prior Law

Overview

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new consumer product or improve a production process, must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered on a disposition or abandonment of the asset, or through depreciation or amortization deductions over the useful life of the asset. However, Code section 174 permits a taxpayer to elect special accounting methods (described below) for certain research or experimental expenditures which are paid or incurred during the taxable year in connection with the taxpayer's trade or business.

Prior law did not provide a tax credit specifically for research or experimental expenditures. However, a taxpayer's investment in machinery and equipment employed in research or experimental activities was eligible for the investment tax credit to the same extent as investments in machinery and equipment employed for business purposes, such as manufacturing, or for current production of income.[1]

Section 174 deduction elections

General rule

Under prior and current law, a taxpayer may elect to deduct currently the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business, even if such expenses are treated as capital account charges or deferred expenses on the taxpayer's books or financial statements (sec. 174(a); Rev. Rul. 58-78, 1958-1 C.B. 148). For example, a taxpayer may elect to expense the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 221; S. Rep. No. 97-144 (July 6, 1981), pp. 75-86; Senate floor amendment, 127 Cong. Rec. S 8489-91 (daily ed. July 27, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 241; H. Rep. No. 97-201 (July 24, 1981), pp. 109-126; H.R. 4242, as passed by the House (July 29, 1981), sec. 221; and H. Rep. No. 97-215 (August 1, 1981), pp. 223-224 (Joint Explanatory Statement of the Committee of Conference).

[1] Under the Accelerated Cost Recovery System enacted in the Act, machinery and equipment used in connection with research and experimentation (as defined in sec. 174) are classified as 3-year recovery property and are eligible for a six-percent regular investment tax credit.

or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months (sec. 174(b)).

If expenditures relating to development of a product are not eligible for these elections, or if the taxpayer chooses not to elect either current deductions or amortization for qualifying research costs, such expenditures must be capitalized.[2]

Depreciation allowances

Expenditures for the acquisition or improvement of land, or expenditures for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation, are expressly excluded from section 174 elections (sec. 174(c)). Thus, for example, the cost of a research building or of equipment used for research cannot be expensed or amortized under section 174. Also, the statute excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, from eligibility for section 174 elections (sec. 174(d)).[3]

However, research expenditures which may be expensed or amortized under section 174 include depreciation (cost recovery) or depletion allowances with respect to depreciable or depletable property used for research (sec. 174(c); Reg. § 1.174-2(b)).

Eligible payments

A taxpayer may elect section 174 expensing or amortization for the costs of research conducted directly by the taxpayer and, in general, for expenses paid or incurred for research conducted on behalf of the taxpayer by another person, such as a research institute, foundation, engineering company, or similar contractor (Reg. § 1.174-2(a)(2)). The Internal Revenue Service has interpreted this regulation as allowing section 174 deductions for payments made by a taxpayer to its industry trade association, or to other nonprofit research organizations representing companies in the same business as the taxpayer, if the payments are to be used solely for research in the field of, and of benefit to, the taxpayer's trade or business.[4] However, amounts paid by the taxpayer which are ex-

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[2] If the capitalized expenses relate to depreciable property, deductions may be taken in the form of depreciation allowances. If the capitalized expenses relate to nondepreciable property, those costs cannot be recovered until disposition or abandonment of the property.

[3] However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

[4] In Rev. Rul. 73-324, 1973-2 C.B. 72, the Revenue Service held that amounts paid by a natural gas company to a tax-exempt industry association (of which it was a member) to be used to provide research plans for developing a coal gasification program qualified for sec. 174 elections. Amounts paid by the taxpayer to the association for this purpose were kept in a separate fund to be used only for the program and were not refundable.

Similarly, in Rev. Rul. 73-20, 1973-1 C.B. 133, the Revenue Service held that payments made by utility companies directly or indirectly to a nonprofit organization formed to carry on a research project in the utility field were deductible by the utility companies pursuant to sec. 174 elections. The research performed was of an investigative nature and intended to develop a model of benefit to the utility field; the utility companies would not, as a result of payments for the project, acquire ownership in land or depreciable property. In addition to deductions for amounts paid directly to the research organization, the ruling also allowed deductions for amounts initially paid both to a nonprofit trade association to which the taxpayers belonged and to a nonprofit organization formed to promote and collect funds for the project, where the payments to those entities from the utility companies in turn were transferred to the research organization.

In Rev. Rul. 69-484, 1969-2 C.B. 38, the Revenue Service ruled that nonrefundable payments made by taxpayers engaged in the business of air transportation to an aircraft manufacturer for

pended by the research entity for land or depreciable property to be used in research carried on for the taxpayer do not qualify for section 174 elections if the taxpayer acquires ownership rights in such property (sec. 174(c); Reg. § 1.174-2(a)(2)).

Definition of qualifying expenditures

The Code does not specifically define "research or experimental expenditures" eligible for the deduction elections (except to exclude certain costs, as described above). Treasury regulations (§ 1.174-2(a)) define the statutory term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned", and also the costs of obtaining a patent on such property.

The regulations provide that qualifying research and experimental expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, section 174 elections cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. § 1.174-2(a)).

Reasons for Change

Need to reverse decline in research activities

Research and experimentation are basic activities that must precede (1) the development and application to production of new techniques and equipment, and (2) the development and manufacture of new products. In recent years, the Congress concluded, spending for these purposes had not been adequate.

In the case of research and development activities conducted by business, company-financed and Federal expenditures over the 12-year period 1968-1979 remained at a fairly stable level in real terms, fluctuating between $19 and $22.8 billion in constant dollars. Relative to real gross national product, such expenditures for company research declined from 2.01 percent in 1968 to 1.58 percent in 1975, essentially remaining at that level since then.

Aggregate research and development spending in this country has experienced a similar period of decline. In 1967, total expenditures reached a high of 2.91 percent of GNP before declining over ten years to 2.26 percent in 1977, and then increasing to an estimated 2.30 percent in 1980. If military and space research expenditures are subtracted from the total, the "civilian" research/GNP ratio for the United States is 1.5 percent, compared with 1.9 percent for Japan and 2.3 percent for West Germany.

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use by the manufacturer solely for research relating to prototype supersonic transport aircraft, and not applied to the purchase price of any aircraft, were deductible by the taxpayers pursuant to sec. 174 elections.

Incentive for increased research spending

In order to reverse this decline in research spending by industry, the Congress concluded that a substantial tax credit for incremental research and experimental expenditures was needed to overcome the reluctance of many ongoing companies to bear the significant costs of staffing and supplies, and certain equipment expenses such as computer charges, which must be incurred to initiate or expand research programs in a trade or business. While such costs have characteristics of investment activity, the relationships between expenditures for research and subsequent earnings often are less directly identifiable, and many businesses have been reluctant to allocate scarce investment funds for uncertain rewards.

The Congress believed that the provisions of the Act, which are designed to stimulate a higher rate of capital formation and increased productivity, appropriately include incentives for greater private activity in research by operating businesses. The new credit applies only to increases in qualified research expenditures, in order to encourage enlarged research efforts by companies which already may be engaged in some research activities. Because of difficulties for taxpayers and the Internal Revenue Service in distinguishing research expenditures from nonresearch expenditures, and in order to limit the credit to principal types of research expenditures which distinctly reflect the extent of increased research activities, the credit is limited to certain direct wage, supply, and equipment research expenditures (or a specified percentage of contract research expenditures). The credit is not allowed for other types of research expenditures, or for indirect, administrative, or overhead expenditures.

Limitations on availability and use of credit

The Congress determined that the new credit is to be available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer, and that (with one exception, described below) the "carrying on" test for purposes of the new credit is the same as for purposes of section 162. For example, it is intended that the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner which is an operating company) for partnership expenditures for "outside" or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments. Also under the "carrying on" test, the Congress intended that research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on (within the meaning of sec. 162) by the taxpayer.

As the only exception to the rule that the "carrying on" test for purposes of the new credit is the same as for purposes of section 162, the Congress intended that the Treasury Department is to issue regulations, for credit purposes only, which will allow the credit in the case of a research joint venture between taxpayers which both (1) themselves satisfy the carrying on test (e.g., the research must be in a particular trade or business already being

carried on by the taxpayer) and also (2) themselves are entitled to the research results.

Furthermore, in cases where an organization conducting research is deemed to be carrying on a trade or business under these rules (so that the credit is available for incremental research expenditures), the Congress determined that individual taxpayers with interests in the organization should not be able to utilize pass-throughs of the credit to offset tax on income from unrelated sources. Thus, the Act provides that individuals (including partners and subchapter S shareholders) to whom the credit is properly allocable may use the credit in a particular year only to offset the amount of tax attributable to that portion of the individual's taxable income which is applicable or apportionable to such interest. (A 15-year carryover is allowed under the Act for any unused credit.) Also, the Act provides that allocations of the credit among partners, etc. must be in accordance with rules prescribed in Treasury regulations.

"Sunset" provision

The new credit for certain incremental research expenditures expires after 1985. Accordingly, the Congress will have an opportunity to evaluate the operation and efficacy of the new credit.

For example, the Congress will be able to evaluate whether the credit operates to stimulate additional research expenditures, or simply rewards increased research expenditures which would have been made in the absence of a credit; whether the categories of qualifying research expenditures should be broadened or narrowed; whether taxpayers and the Internal Revenue Service have been able accurately to distinguish qualifying research expenditures from nonqualifying research-related expenditures, such as indirect, overhead, or administrative wage expenditures, and from nonresearch expenditures, such as costs of market research, quality control, or production; whether the base period computation rules are appropriate; and whether the restrictions and limitations on the availability and use of the credit (e.g., the "carrying on" requirement) have been effective to accomplish the Congressional intent.

Explanation of Provision

Overview

Under the Act, a nonrefundable income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (new sec. 44F). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

For purposes of the credit, the Act adopts the definition of research used for purposes of the special deduction rules under Code section 174, but subject to certain exclusions. A taxpayer's research expenditures eligible for the new incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and

supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to expense or amortize research expenditures. The amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for qualified research expenditures.

Trade or business requirement

Under the Act, the credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With the one exception described below, this "carrying on" test for purposes of the new credit is the same as for purposes of the business deduction provisions of section 162.

For example, it is intended that to be eligible for the credit, research expenditures must be paid or incurred in a particular trade or business being carried on (within the meaning of sec. 162) by the taxpayer; no credit is available for expenditures for research relating to a potential trade or business which the taxpayer is not carrying on at the time the research expenditures are made. Thus, the credit is not available (either for current or carryover use) to a new entity which undertakes research with a view to using the resulting technology through future production and sales, and is not available to an ongoing business which undertakes research with a view to entering a new trade or business. Under the trade or business test of new section 44F, the credit is not available for research expenditures paid or incurred prior to the commencement of a trade or business. If a taxpayer carries on (within the meaning of sec. 162) more than one trade or business, research expenditures paid or incurred in carrying on any of the taxpayer's trades or businesses are eligible for the credit, provided that such expenditures are paid or incurred by the taxpayer in a particular trade or business being carried on by the taxpayer.

The new credit is not available for research expenditures paid or incurred by a taxpayer merely in connection with, but not in carrying on, a trade or business. Similarly, the credit is not available with respect to expenditures paid or incurred by a taxpayer as part of a financing arrangement or hobby.

The rule that only research expenditures paid or incurred by the taxpayer in carrying on a trade or business are eligible for the credit is a more stringent requirement than that which has been deemed applicable for purposes of section 174 (relating to research expenditures which are paid or incurred "in connection with" the taxpayer's trade or business).

For example, under the trade or business test of new section 44F, the credit generally is not available with regard to a taxpayer's expenditures for "outside" or contract research intended to be

transferred by the taxpayer to another in return for license or royalty payments. (Receipt of royalties does not constitute a trade or business under present law, even though expenses attributable to those royalties are deductible from gross income in arriving at adjusted gross income.) In such a case, the nexus, if any, between research expenditures of the taxpayer and activities of the transferee to which research results are transferred (e.g., any use by an operating company, that is the general partner in a limited partnership which makes the research expenditures, of the research results in the operating company's trade or business) generally will not characterize the taxpayer's expenditures as paid or incurred in carrying on a trade or business *of the taxpayer.* (Under appropriate circumstances, nevertheless, the nexus might be deemed adequate for purposes of the section 174 deduction elections.) If, however, the taxpayer used the product of the research in a trade or business of the taxpayer, as well as licensing use of the product by others, the relationship between the research expenditures of the taxpayer (i.e., those research expenditures paid or incurred after such time as the taxpayer is considered to be carrying on the trade or business in which such expenditures are paid or incurred) and the taxpayer's trade or business in which the research expenditures are paid or incurred generally would be sufficient for credit purposes.

The transfer to or acquisition by an entity of trade or business assets or activities which are nominal in comparison with the extent of research conducted or contracted for by the entity will not itself be sufficient to characterize the entity's expenditures for research as paid or incurred in carrying on a trade or business.

As the only exception to the rule that the "carrying on" test for purposes of the new credit is the same as for purposes of section 162, the Congress intended that the Treasury Department is to issue regulations, for credit purposes only, which will allow the credit in the case of a research joint venture between taxpayers which both (1) themselves satisfy the carrying on test (e.g., the research must be in a particular trade or business already being carried on by the taxpayer) and also (2) themselves are entitled to the research results.

Definition of qualifying research

General rule

Subject to certain exclusions, the provision adopts the definition of research as used in Code section 174. That is, the term "qualified research" for purposes of new section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174.[5]

[5] While the definition of research generally is the same for purposes both of sec. 174 deduction elections and the new credit, particular research expenditures which qualify for the sec. 174 deduction elections may be ineligible for the credit, e.g., because the expenditures fail to satisfy the trade or business requirement for the credit, because the expenditures do not fall within the categories of research expenditures (such as direct research wages) which qualify for the credit, or because the expenditures fall within one of the exclusions from the credit.

By way of illustration, research expenditures may be deductible under sec. 174 if paid or incurred in connection with the taxpayer's trade or business, but enter into the credit computation only if paid or incurred in carrying on a trade or business of the taxpayer. Also, certain categories of research expenditures, such as indirect research expenditures or depreciation allowances, may be eligible for the sec. 174 deduction elections but are not eligible for the new

As described above, the term "research or experimental expenditures" as used in section 174 means "research and development costs in the experimental or laboratory sense" (Reg. §1.174-2 (a)). This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned", and the costs of obtaining a patent on such property.

Expenditures which are ineligible for the section 174 deduction elections also are not eligible for the new credit. These ineligible expenditures include expenditures for the acquisition or improvement of land or of certain depreciable or depletable property used in research (sec. 174(c)), expenditures for the purpose of ascertaining the existence, location, extent, or quality of mineral deposits, including oil and gas (sec. 174(d)), and the costs of acquiring another person's patent, model, production, or process (Reg. § 1.174-2(a)).

Computer software development costs

The Internal Revenue Service has taken the position that certain costs of developing computer software may be treated in a manner similar to costs incurred in product development which are subject to section 174 deduction elections (Rev. Proc. 69-21, 1969-2 C.B. 303). For this purpose, the cost of developing computer software means costs incurred in developing new or significantly improved programs or routines that cause computers to perform desired tasks (as distinguished from other software costs where the operational feasibility of the program or routine is not seriously in doubt).

For purposes of the new credit, the Congress intended that otherwise qualifying types of expenditures (for example, direct wage expenditures) which are part of the costs of otherwise qualifying research for the development of new or significantly improved computer software are to be eligible for the credit to the extent that such expenditures (1) are treated as similar to costs, incurred in product research or experimentation, which are deductible as research or experimental expenditures under section 174; (2) satisfy the requirements of new section 44F which apply to research expenditures, including the trade or business requirement; and (3) do not fall within any of the specific exclusions in new section 44F. That is, expenditures for developing new or significantly improved computer programs which otherwise would qualify for the new credit are not to be disqualified solely because such costs are incurred in developing computer "software", rather than in developing "hardware."

The credit limitations and definitional restrictions (such as the distinctions between research and nonresearch expenditures, and between direct and indirect expenditures, discussed below) which apply in the case of product research and experimentation costs also apply in the case of the costs of developing new or significantly improved computer software.

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credit. As a further example, expenditures for research conducted outside the United States may qualify for sec. 174 deduction elections but are excluded from eligibility for the credit.

Nonresearch expenditures

Under the provision, the credit is not available for expenditures such as the costs of routine or ordinary testing or inspection of materials or products for quality control; of efficiency surveys or management studies; of consumer surveys (including market research), advertising, or promotions (including market testing or development activities); or of routine data collection. Also, costs incurred in connection with routine, periodic, or cosmetic alterations or improvements (such as seasonal design or style changes) to existing products, to production lines, or to other ongoing operations, or in connection with routine design of tools, jigs, molds, and dies, do not qualify as research expenditures under the provision.

The provision does not allow the new credit for such expenditures as the costs of construction of copies of prototypes after construction and testing of the original model(s) have been completed; of pre-production planning and trial production runs; of engineering follow-through or trouble-shooting during production; or of adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity. For example, the costs of adapting existing computer software programs to specific customer needs or uses, as well as other modifications of previously developed programs, are not eligible for the credit.

Exclusions

The provision sets forth three express exclusions from the definition of qualified research for purposes of the new credit.

First, expenditures for research which is conducted outside the United States do not enter into the credit computation, whether or not the taxpayer is located or does business in the United States; the test is whether the laboratory experiments, etc., actually take place in this country.

Second, the credit is not available for research in the social sciences or humanities (including the arts), such as research on psychological or sociological topics or management feasibility studies.

Third, the credit is not available for research to the extent funded by any grant, contract, or otherwise by another person (or any governmental entity).[6]

In-house expenditures for wages

General rule

The first category of in-house research expenditures qualifying for the new credit consists of wages paid or incurred to an employee for qualified services performed by such employee.

Under the provision, the term "wages" has the same meaning as provided in section 3401(a) for purposes of employee wage withholding. Thus, amounts of compensation which are not subject to with-

[6] In recognition of variations among contractual arrangements involving payments or accounting for research costs, the Congress intends that the Treasury Department is to issue regulations, under this provision, for purposes of determining to what extent research expenditures, such as "independent research and development" costs of a government contractor, may qualify for the new credit.

holding, such as certain fringe benefits, do not enter into the credit computation even though paid for services in performing research. In the case of self-employed individuals and owner-employees, the term "wages" for purposes of the new credit includes earned income of such individuals as defined in section 401(c), and such individuals are treated as employees for purposes of the wages category of in-house qualified research.

Any amount of wages taken into account in computing either the targeted jobs tax credit (sec. 44B) or the WIN credit (sec. 40) does not enter into the credit computation.

Amount of wages eligible for credit

As a general rule, wages enter into the credit computation only to the extent paid or incurred for that portion of the services performed by an employee of the taxpayer which constitute "qualified services" (as discussed below). For example, if an employee spends part of his or her time during the year conducting research, part of the time engaged in production or marketing activities, and part of the time providing general or administrative services, only the amount of wages actually paid or incurred for services performed in conducting research enters into the credit computation. The allocation of wages between qualified services and other services is to be made in a consistent manner, in accordance with Treasury regulations, on the basis of time or other appropriate factors.

If substantially all (for this purpose, at least 80 percent) of the services performed by an employee for the taxpayer during a taxable year constitute qualified services, then all services performed by that individual for the taxpayer during the year are treated as qualified services. Thus, if 90 percent of the services performed by an employee for the taxpayer during a taxable year are performed in conducting research, all wages paid by the taxpayer during the taxable year to that individual enter into the credit computation, even though the remaining amount of the individual's services for the taxpayer was not performed in conducting research.

Definition of qualified services

General requirements

A taxpayer's wage expenditures enter into the credit computation only to the extent that they constitute wages paid or incurred for qualified services. That is, the wages must be paid for engaging in the actual conduct of research (as in the case of a laboratory scientist engaging in experimentation), must be paid for engaging in the immediate supervision of the actual conduct of qualified research (as in the case of a research scientist who directly supervises laboratory scientists engaged in qualified research, but who may not actually conduct experiments), or must be paid for engaging in the direct support of the actual conduct (or of the immediate supervision of the actual conduct) of qualified research. The "support" category of qualified services would include, for example, the services of a laboratory assistant in entering research data into a computer as part of the conduct of research, of a secretary in typing reports describing the laboratory research results, of a labo-

ratory worker in cleaning research equipment, or of a machinist in machining a part of an experimental model.

Ineligible expenditures

Since only wages paid for qualified services enter into the credit computation, no amount of wages paid for overhead or for general and administrative services, or of indirect research wages, qualifies for the new credit. Thus, no amount of overhead, general and administrative, or indirect wage expenditures is eligible for the new credit, even if such expenditures relate to the taxpayer's research activities, and even if such expenditures may qualify for section 174 deduction elections or may be treated as research expenditures for accounting and financial purposes. By way of illustration, expenditures not eligible for the credit include such items as wages paid to payroll personnel for preparing salary checks of laboratory scientists, wages paid for accounting services, and wages paid to officers and employees of the taxpayer who are not engaged in the actual conduct, immediate supervision, or direct support of qualified research although engaged in activities (such as general supervision of the business or raising capital for expansion) which in some manner may be viewed as benefiting research activities.

Other in-house expenditures

General rules

The second category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for supplies used in the conduct of qualified research. The provision defines the term "supplies" to mean any tangible property other than (1) land or improvements to land or (2) property of a character subject to the allowance for depreciation (cost recovery). Neither the cost of acquisition of, nor the amount of depreciation (cost recovery) allowances with respect to, property which is of a character subject to the depreciation (cost recovery) allowance is eligible for the credit, whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be "expensed."

The final category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for the right to use personal property in the conduct of qualified research, if such amounts are paid to a person other than the taxpayer. Intracompany charges for the right to use personal property in the conduct of research are not eligible for the credit. Also, by virtue of the rules in the provision for aggregation of research expenditures among commonly controlled taxpayers, etc. (described below), amounts paid or incurred to a person whose research expenditures are aggregated with those of the taxpayer for the right to use personal property in the conduct of research are not eligible for the credit. For example, amounts paid by a parent corporation to a subsidiary for use of a computer in the conduct of research by the parent do not qualify for the credit, because (by virtue of the aggregation rules) such amounts are not treated as paid by the taxpayer to another person.

Requirements for qualification

Determinations of whether and to what extent research expenditures of a taxpayer qualify under the second or third categories of in-house research expenditures are to be made in accordance with the rules, described and illustrated above, applicable in determining whether and to what extent wage expenditures qualify for the credit. Thus, for example, the credit is not available for expenditures for supplies, or for the use of personal property, if such expenditures constitute indirect research expenditures, or if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities).

By way of illustration, supplies eligible for the credit include supplies used in experimentation by a laboratory scientist, in the entering by a laboratory assistant of research data into a computer as part of the conduct of research, or in the machining by a machinist of a part of an experimental model. On the other hand, supplies used in preparing salary checks of laboratory scientists or in performing financial or accounting services for the taxpayer (even if related to individuals engaged in research) are not eligible for the new credit. Similarly, amounts paid to another person as computer user charges for use of a computer in the conduct of qualified research are eligible for the credit, but computer user charges paid for use of a computer for payroll preparation, inventory purposes, routine data collection, market research, production quality control, etc., are not eligible.

Contract research expenditures

General rules

In addition to the three categories of in-house research expenditures, 65 percent of amounts paid or incurred by the taxpayer, in carrying on a trade or business of the taxpayer, to any person (other than an employee of the taxpayer) for qualified research performed on behalf of the taxpayer enters into the incremental credit computation. (The determination of whether payments from a taxpayer to another person constitute contract expenditures for research to be conducted on behalf of the taxpayer depends on all the facts and circumstances of the particular research arrangement.) No other amounts of contract research, nor any other expenditures for "outside" research (except pursuant to the special rule for certain basic research, discussed below), are eligible for the credit.

In the case of contract research, only the taxpayer which, in carrying on a trade or business of the taxpayer, makes payments under the contract and on whose behalf the research is conducted is eligible to claim the new credit. The research firm, university, or other person which conducts the research on behalf of the taxpayer cannot claim any amount of the new credit for its expenditures in performing the contract.

Prepayment limitation rule

If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, such amount is treated as paid or

incurred during the period during which the qualified research is actually conducted. For example, if on December 1, 1982, a calendar-year taxpayer pays $100,000 to a research firm pursuant to a contract for qualified research to be performed on behalf of the taxpayer, and if the research firm conducts all of such qualified research during 1983, no amount is eligible for a credit for 1982, and $65,000 (65 percent of the total contract price) is treated as research expenditures of the taxpayer paid during 1983.

Amounts which are treated as contract research expenditures during a particular taxable year pursuant to the prepayment limitation rule, and hence which count as expenditures for such year entering into the credit computation for such taxable year, also are treated as having been made during that same taxable year for purposes of determining average yearly base period expenditures in later year credit computations. Thus, in the example given above, $65,000 enters into the taxpayer's 1983 credit base.

Effect of aggregation rules

By virtue of the rules in the provison for aggregation of research expenditures among commonly controlled taxpayers, etc. (described below), the contract expenditure rule does not apply to a contract between a taxpayer and any person whose research expenditures are aggregated with those of the taxpayer.

For example, assume that a parent corporation paid $100,000 to a subsidiary pursuant to a contract with the subsidiary to conduct research on behalf of the parent. Assume further that the subsidiary completed the research in that same taxable year, and in the research expended $59,375 for expenditures (such as direct research wages) which would be treated as qualified research expenditures if the parent had made such expenditures directly in conducting the project as in-house research. By virtue of the aggregation rules in the provision, the only amounts of the total $100,000 expenditures under the contract which enter into the credit computation would be $59,375, and not 65 percent of the contract amount.

Expenditures for certain basic research

Overview

The provision includes a special rule which treats as contract research expenditures 65 percent of certain corporate expenditures (including grants or charitable contributions) for basic research to be performed at a college, university, or other qualified organization. Under this rule, a corporate taxpayer takes into account, for purposes of computing the incremental credit, 65 percent of qualifying basic research expenditures (subject to the contract research prepayment limitation).

Illustration of computation

For example, assume that a corporation (which is eligible for the special rule) makes qualified in-house research expenditures (i.e., research expenditures which satisfy the definition in the Act of qualified in-house research expenditures) totalling $120 million in each of the years 1980, 1981, and 1982. In addition, in 1981 the corporation makes a $6 million grant to a university for basic research which satisfies the definition of qualifying basic research

expenditures under the special rule; all of this amount is expended by the university in that year. In 1983, the corporation makes qualified in-house research expenditures totalling $130 million and also contributes $3 million to a university for basic research pursuant to a written research agreement. The university expends 50 percent of the 1983 contribution funds during 1983 and the rest during 1984.

Under these facts, the corporation's qualified research expenditures for 1983 would equal $130 million *plus* 65 percent of $1.5 million ($975,000). The corporation's base period expenditures [7] with respect to 1983 would be the average of its qualified research expenditures for 1980, 1981, and 1982, or $121,300,000. Accordingly, the 25 percent credit for 1983 would apply to the excess of total current-year expenditures ($130,975,000) over the base period average ($121,300,000), or $9,675,000.

Assume further that in 1984 the total of the corporation's qualified in-house research expenditures increases to $135 million, and that the corporation makes no new basic research expenditures. The corporation is treated as having qualifying basic research expenditures in 1984 equal to 65 percent of $1.5 million, or $975,000. The corporation's base period expenditures with respect to 1984 would be the average of qualified research expenditures for 1981 ($123,900,000), 1982 ($120 million), and 1983 ($130,975,000). Accordingly, the 25 percent credit for 1984 would apply to the excess of current-year expenditures ($135,975,000) over the base period average ($124,958,333), or $11,016,667.

General requirements

The special rule for basic research applies only to corporate expenditures paid or incurred pursuant to a written research agreement between the taxpayer corporation and a college, university, or other qualified organization. Moreover, in the case of certain qualified fund recipients, the fund also must make disbursements to colleges or universities for basic research pursuant to written research agreements.

For purposes of this special rule, the term "basic research" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. However, the term basic research does not include expenditures for any activity excluded from the definition of qualified research (described above), e.g., expenditures for basic research conducted outside the United States or expenditures for basic research in the social sciences or humanities (including the arts).

The special basic research rule does not apply to research expenditures by corporations that are subchapter S corporations (sec. 1371(b)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

Definition of qualified organizations

The special basic research rule applies only to corporate expenditures for basic research to be conducted by a qualified organization. For this purpose, the term "qualified organization" generally in-

[7] The rules of the provision for computation of base period expenditures are discussed in the text below.

cludes colleges or universities and certain tax-exempt scientific organizations.

The first category of qualified organizations are educational organizations that both (1) are described in section 170(b)(1)(A)(ii) and (2) constitute institutions of higher education as defined in sec. 3304(f). Scientific organizations that qualify under the special basic research rule are organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to entities organized and operated exclusively for specified purposes) and exempt from tax under section 501(a), and (3) are not private foundations.

Qualified fund grants

The special basic research rule also applies to certain corporate grants to qualified funds. Such grants must be made pursuant to a written research agreement between the corporation and the fund, and must be disbursed from the fund to a college or university (as defined above) under a written research agreement for purposes of basic research.

The provision defines a qualified fund as any electing organization, other than a private foundation, which is exempt from tax (under sec. 501(a)) and is described in section 501(c)(3) (relating to entities organized and operated exclusively for specified purposes). In addition, the fund must be organized and operated exclusively (and not merely primarily) for purposes of making grants, pursuant to written research agreements, to colleges or universities for purposes of basic research. The fund must be established and maintained by an organization (established before July 10, 1981) which is described in section 501(c)(3) and is exempt from tax under section 501(a), and which is not a private foundation.

An organization will not constitute a qualified fund unless it elects to be treated as a private foundation for all Code purposes other than the section 4940 excise tax on investment income. For example, in order to avoid excise taxes under section 4942, the qualified fund annually must make grants to colleges or universities, under written research agreements for purposes of basic research, at least equal to its "minimum investment return," defined generally as five percent of the fund's investment assets (sec. 4942 (e)). An election may be revoked only with the consent of the Treasury Department.

Computation of allowable credit

General rule

The credit applies to the excess of the taxpayer's qualified research expenditures for the taxable year over the average of the taxpayer's yearly qualified research expenditures during the base period.

As a general rule, the credit applies to the amount of qualified research expenditures for the current taxable year which exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. However, for the taxpayer's first taxable year to which the new credit applies (and which ends in 1981 or 1982), the credit applies to the amount of qualified research expenditures for that year which exceeds the amount of such ex-

penditures in the preceding taxable year (see discussion below of transitional base period computation). Also, for the taxpayer's second taxable year to which the new credit applies (and which ends in 1982 or 1983), the credit applies to the amount of qualified research expenditures for that year which exceeds the average of yearly qualified research expenditures in the preceding two taxable years.

Transitional base period computation

Because the provision is effective for qualified research expenditures paid or incurred after June 30, 1981, a special rule is provided for computing base period of expenditures with respect to the first taxable year of a taxpayer to which the new credit applies if such year ends in 1981 or 1982 (i.e., the taxpayer's taxable year which includes July 1, 1981). In that case, the taxpayer's base period expenditures equal the total qualified research expenditures for the preceding taxable year multiplied by a fraction, the numerator of which is the number of months between June 30, 1981 and the end of the taxpayer's first taxable year ending after that date, and the denominator of which is the number of months in such entire year. A similar rule will apply in the case of a taxpayer's first taxable year ending after December 31, 1985.

For example, assume a calendar-year taxpayer has research expenditures as follows: $100,000 for 1980; $60,000 for the period January 1, 1981 through June 30, 1981; and $70,000 for the period July 1, 1981 through December 31, 1981. The base period amount would equal $100,000 times 6/12ths, or $50,000; thus, the credit for 1981 would apply to the difference between $70,000 and $50,000. If the taxpayer's research expenditures for 1982 are $150,000, the credit for 1982 would apply to the difference between (1) that amount and (2) $115,000, which is the average of 1980 expenditures ($100,000) and total 1981 expenditures ($130,000).

New businesses

If the taxpayer, or a related person whose research expenditures are aggregated with those of the taxpayer (pursuant to the rules discussed below), was not in existence during a base period year, then the taxpayer, or the related person, is treated as having research expenditures of zero in such year, for purposes of computing average annual research expenditures during the base period (see discussion below of the 50-percent limitation rule).

50-percent limitation rule

The Act provides that in no event shall base period research expenditures be less than 50 percent of qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

For example, assume that a calendar-year taxpayer is organized January 1, 1983; makes qualified research expenditures of $100,000 for 1983; and makes qualified research expenditures of $260,000 for 1984. The new-business rule (described above) provides that the taxpayer is deemed to have base period expenditures of zero for pre-1983 years. Without regard to the 50-percent limitation, the

taxpayer's base period expenditures for purposes of determining any credit for 1984 would be the average of its expenditures for 1981 (deemed to be zero), 1982 (deemed to be zero), and 1983 ($100,000), or $33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures ($260,000), or $130,000. Accordingly, the amount of 1984 qualified research expenditures qualifying for the credit is limited to $130,000, and the amount of the taxpayer's credit for 1984 is $32,500.

Short taxable years

If the taxpayer has a short taxable year, research expenditures for that year are to be annualized to the extent provided in Treasury regulations.

Pass-through of credit

The Act also provides that under Treasury regulations, rules similar to those used with respect to the targeted jobs credit (secs. 52(d) and 52(e)) will apply for purposes of apportioning the credit earned by a subchapter S corporation, or by a trust or estate, to the shareholders or beneficiaries. In the case of partnerships, the Act provides that the credit is to be allocated among the partners as provided in Treasury regulations.

Rules for aggregation of expenditures

General rule

To ensure that the new credit will be allowed only for actual increases in research expenditures, the Act includes rules under which research expenditures of the taxpayer are aggregated with research expenditures of other persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Under the provision, all qualified research expenditures of all corporations that are members of a "controlled group of corporations" are treated as if made by one taxpayer. For this purpose, the same controlled group test (50-percent control) is used as applies under rules for computing the targeted jobs tax credit (sec. 52(a)).[8] Any research credit earned by a controlled group, computed pursuant to this aggregation rule, is to be apportioned among members of the group on the basis of the member's proportionate share, if any, of the increase in aggregate qualified research expenditures giving rise to the credit.

The provision also requires aggregation, pursuant to Treasury regulations, of all qualified research expenditures of partnerships, proprietorships, and any other trades or businesses (whether or not incorporated) which are under common control. Any allowable research credit, computed pursuant to this aggregation rule, is to be apportioned, as provided in Treasury regulations, among the per-

[8] That is, the term "controlled group of corporations" has the same meaning for purposes of the aggregation rule as under sec. 1563(a), except that (1) "more than 50 percent" is substituted for "at least 80 percent" each place the latter term appears in sec. 1563(a)(1), and (2) the determination is made without regard to subsections (a)(4) and (e)(3)(C) of sec. 1563.

sons whose expenditures are aggregated on the basis of the person's proportionate share, if any, of the increase in aggregate research expenditures giving rise to the credit. This aggregation and apportionment rule is to be based on principles similar to the principles applicable in the case of a controlled group of corporations.

Example

The following example illustrates the method of apportioning the credit among persons whose research expenditures are aggregated pursuant to the rules discussed above.

Assume that a controlled group of four corporations has qualified research expenditures during the base period and taxable year as follows:

[In thousands of dollars]

Corporation	Base period (average)	Taxable year	Change
A	$60	$40	($20)
B	10	15	5
C	30	70	40
D	15	25	10

Treating these research expenditures of the four corporations as if made by one taxpayer, the total amount of incremental expenditures eligible for the credit is $35,000 ($55,000 increase attributable to B, C, and D less $20,000 decrease attributable to A). The total amount of credit allowable to members of the group is 25 percent of the incremental amount, or $8,750.

No amount of credit is apportioned to A, since A's qualified research expenditures did not increase in the taxable year. The full $8,750 credit would be allocated to B, C, and D, i.e., to those members of the group with increases in their expenditures. This allocation would be made on the basis of the ratio of each such corporation's increase in its qualified research expenditures to the sum of increases in such expenditures (counting only members with increases). Inasmuch as the total increase made by those members of the group whose research expenditures went up (B, C, and D) was $55,000, B's share of the $8,750 credit is 5/55; C's share is 40/55; and D's share is 10/55.

If, in the example set forth above, A had zero expenditures in the taxable year, the controlled group as a whole would show a decrease rather than an increase in aggregate expenditures. In that case, no amount of credit would be allowable to any member of the group even though B, C, and D actually increased their research expenditures in comparison with their own base period expenditures.

Rules for changes in business ownership

General rule

The Act includes special rules for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

If the Act did not include rules for changes in ownership of a business, a taxpayer who begins business by buying and operating an existing company might be entitled to a credit even if the amount of qualified research expenditures did not increase. Also, the sale of a unit of a business could cause the seller to lose any credit even though qualified research expenditures increased in the part of the business that was retained. These rules for changes in business ownership, described below, are to apply under Treasury regulations.

Acquisitions

Under the provision, if a taxpayer acquires (after June 30, 1980) the major portion of a trade or business (or of a separate unit thereof) of another person, the credit allowable to the taxpayer for any taxable year ending after the acquisition is to be computed by increasing the taxpayer's qualified research expenditures for periods before the acquisition by the amount of qualified research expenditures of the predecessor which are attributable to the acquired business (or separate unit).

Under these rules, a taxpayer is not to be treated as acquiring the major portion of a trade or business (or of a separate unit thereof) merely because the taxpayer acquires some assets used in that trade or business. Instead, this determination is to be made on the basis of whether the transaction involves the acquisition of assets, constituting all or the major portion of a trade or business (or of a separate unit thereof) of the predecessor, which assets the taxpayer could operate as a separate or distinct trade or business.

Dispositions

The provision also includes rules for computing the amount of incremental expenditures if a taxpayer disposes (after June 30, 1980) of the major portion of a trade or business (or of a separate unit thereof) in a transaction to which the above acquisition rules apply.

In determining the credit allowable to the taxpayer for a taxable year ending after the disposition, the taxpayer's qualified research expenditures for periods before the disposition generally are to be decreased by the amount of the taxpayer's qualified research expenditures attributable to the portion of the business (or separate unit) which has changed hands. (This rule permits a taxpayer which operates two businesses to sell one and nevertheless earn a credit for increased research expenditures in the retained business.) This relief is not provided unless the taxpayer furnishes the

acquiring person with information needed to compute the credit under the acquisition rules described above.

However, the base period expenditures of a taxpayer which so disposes of a trade or business (or separate unit) will be increased if, during any of the three taxable years following the year of disposition, the taxpayer (or a person whose research expenditures must be aggregated under the provision with those of the taxpayer) reimburses the acquiring person (or a person whose research expenditures must be aggregated under the provision with those of the acquiring person) for research on behalf of the taxpayer. In such a case, the amount of qualified research expenditures of the taxpayer for the base period for such taxable year shall be increased by the lesser of (1) the amount of decrease (under the disposition rules described in the preceding paragraph) which is allocable to such base period, or (2) the product of the number of years in the base period multiplied by the amount of such reimbursement.

Limitations and carryover

General limitation

The amount of credit which may be used in a particular taxable year is limited to the taxpayer's income tax liability reduced by certain other nonrefundable credits.[9]

Additional limitation on individuals

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in a subchapter S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest. For example, if in a particular year an individual partner derives no taxable income from a partnership which had made incremental qualified research expenditures, the individual may not use in that year any tax credit resulting from incremental qualified research expenditures of such partnership which otherwise would have been properly allowable to the partner (e.g., where the partnership had paid such research expenditures in carrying on a trade or business of the partnership and where any credit allowable to the partnership with respect to such expenditures had been properly allocated among the partners pursuant to Treasury regulations, as provided by the Act). If in this example the partner had derived taxable income allocable or apportionable to the individual's partnership interest, then the amount of credit which may

[9] That is, after computation of income tax liability, the credits allowed by part IV of subchapter A of the Code are taken in numerical and alphabetical order, with the exception of the refundable credits provided by secs. 31, 39, and 43. If such lower numbered or lower lettered credits eliminate the taxpayer's tax liability, no credit under new sec. 44F is allowable in that year. For example, if the credits provided by secs. 38 and 44D reduce income tax liability to zero, no sec. 44F credit is allowable in that year. If such lower numbered or lower lettered credits reduce but do not eliminate the taxpayer's tax liability, the credit otherwise available under new sec. 44F is allowable in that year only to the extent of the taxpayer's income tax liability after reduction by such credits.

be used in that year by the individual partner may not exceed the lesser of the general limitation amount (described above) or the separately computed additional limitation amount applicable to individuals.

Carryover

If the amount of credit otherwise allowable exceeds the applicable limitation, the excess amount of credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward 15 years, beginning with the earliest year.[10] The limitations discussed above also apply to each carryback or carryforward year.

Effective Date

The provision applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $448 million in 1982, $708 million in 1983, $858 million in 1984, $847 million in 1985, and $485 million in 1986.

[10] In conformity with these credit carryover rules, sec. 221(b) of the Act makes technical amendments to Code sec. 55(c)(4), relating to carryover and carryback of certain credits in connection with the alternative minimum tax; sec. 381(c), relating to carryover items of the distributor or transferor corporation in certain corporate acquisitions; sec. 383, relating to special limitations on carryovers of certain credits, etc.; the table of Code sections relating to carryovers; sec. 6511(d)(4)(C), defining credit carrybacks in connection with refund claims; and sec. 6411, relating to quick refunds in respect to tentative carryback adjustments.

Also, sec. 221(c) of the Act makes technical and clerical amendments to Code sec. 6096(b), defining income tax liability for purposes of rules on payments to the Presidential Election Campaign Fund, and to the table of Code sections relating to allowable income tax credits.

2. Charitable contributions of scientific property used for research or experimentation purposes (sec. 222 of the Act and sec. 170(e) of the Code)*

Prior Law

Overview

A corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations for exempt purposes, including contributions to colleges and universities for research purposes (Code sec. 170). This charitable deduction is limited to a percentage [1] of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

General reduction rule

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)).[2] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally can deduct only the donor's basis in the property, rather than its full fair market value.

Exception

In 1976, an exception to this general reduction rule was enacted for contributions by corporations of certain types of ordinary income property (e.g., medical equipment) donated for the care of the needy, the ill, or infants (sec. 170(e)(3)(A)). In the case of such a qualifying charitable contribution of inventory, this exception generally allows a deduction equal to the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation. However, in no event is a deduction allowed for an amount in excess of twice the basis of the property.

This exception was enacted because the Congress concluded that it was desirable to provide a greater tax incentive than in prior law for contributions of certain types of ordinary income property for

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 222; S. Rep. No. 97-144 (July 6, 1981), pp. 87-89; H.R. 4242, as reported by the House Ways and Means Committee, sec. 242; H. Rep. No. 97-201 (July 24, 1981), pp. 127-129; H.R. 4242, as passed by the House (July 29, 1981), sec. 222; and H. Rep. No. 97-215 (August 1, 1981), p. 224 (Joint Explanatory Statement of the Committee of Conference).

[1] Prior to the Act, this limitation was five percent. Effective for taxable years beginning after December 31, 1981, the Act increases the deduction limitation to ten percent.

[2] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

the specified category of exempt purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Reasons for Change

The Congress concluded that an additional incentive would be desirable to encourage manufacturers to contribute "state-of-the-art" scientific equipment to colleges and universities for use in research activities.

Academic research and development expenditures have increased in constant dollars by three percent each year since 1974, reversing a spending decline over the prior six years. However, studies indicate that in equipment-intensive research areas such as physics, chemistry, and electrical engineering, the continuing growth of university expenditures has not kept pace with the rising costs of scientific instrumentation.

The general deduction limitation rule, enacted in the Tax Reform Act of 1969, has been effective to prevent situations which led to its enactment, in which individual taxpayers in high marginal tax brackets or corporations could donate to charity substantially appreciated ordinary income property and be better off, after tax, than they would have been had they sold the property and retained all the after-tax proceeds. At the same time, the 1969 rule has resulted in reduced contributions of certain types of property to charities, including educational institutions.

The Congress has concluded that demonstrated deficiencies in scientific instrumentation and equipment used in colleges and universities for research and research training make it appropriate to provide a greater tax incentive than in present law for contributions of certain types of new inventory property, manufactured by the donor corporation no more than two years before contribution, which the donee university or college uses in carrying on scientific research activities, including research training. The Congress also believed that the deduction so allowed should not be such that the donor corporation could be in a better after-tax situation by donating the property than by selling it.

Explanation of Provision

Overview

The provision provides an additional limited exception to the rules which generally require an otherwise allowable deduction for charitable contributions of appreciated property to be reduced by the amount which would not be long-term capital gain if the property contributed had been sold at its fair market value at the time of the contribution.

The provision allows corporations (with certain exceptions [3]) a larger deduction than under prior law for charitable contributions of new tangible personal property which is of an inventory nature (within the meaning of sec. 1221(1)), if contributed to an institution

[3] The provision does not apply in the case of a corporation which is a subchapter S corporation, as defined in sec. 1371(b); a personal holding company, as defined in sec. 542; or a service organization, as defined in sec. 414(m)(3).

of higher education (as defined in secs. 170(b)(1)(A)(ii) and 3304(f)), and if used by the college or university for research purposes.

Requirements for favorable treatment

To qualify, a corporate contribution of ordinary-income property to a college or university must satisfy the following requirements:

(1) The property contributed was constructed by the taxpayer;[4]

(2) The contribution is made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the donee;

(4) The property is scientific equipment or apparatus substantially all the use of which by the donee is for research or experimentation (within the meaning of Code sec. 174), or for research training in the United States in the physical or biological sciences;[5]

(5) The property is not transferred by the donee in exchange for money, other property, or services; and

(6) The taxpayer receives the donee's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction is generally for the sum of (1) the taxpayer's basis in the property and (2) one-half of the unrealized appreciation (i.e., one-half of the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value determined at the time of the contribution). However, in no event is a deduction allowed for an amount which exceeds twice the basis of the property.

Effective Date

The provision applies to charitable contributions made after the date of enactment of the Act (August 13, 1981), in taxable years ending after that date.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

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[4] The Act provides that, under Treasury regulations, property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property.

[5] For purposes of the fourth requirement listed above, the term "substantially all" means at least 80 percent. Donated inventory-type property will qualify under this use requirement if substantially all the use by the donee is for the conduct of research, if substantially all the use by the donee is for training to conduct research, or if substantially all the use by the donee is for a combination of such research and research training.

For example, a charitable contribution of an electron microscope or a computer by the manufacturer will satisfy the use requirement if substantially all the use by the donee college or university consists of training undergraduate or graduate students (either in a laboratory or in a classroom) in how to use the microscope or computer in research, consists of research experiments conducted by such students, e.g., laboratory experiments as part of an undergraduate science course, or consists of a combination of such research and research training.

For purposes of this provision, the physical sciences include physics, chemistry, astronomy, mathematics, and engineering, and the biological sciences include biology and medicine.

3. Rule for allocating research and experimental expenditures to U.S.-source income (sec. 223 of the Act and sec. 861 of the Code)*

Prior Law

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation (sec. 904), and for other tax purposes, sections 861–863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income. Treasury regulation § 1.861–8 sets forth rules for allocating and apportioning these expenses.

Under this regulation, research and development expenditures ("research expenses") are allocated to income based on a broad classification of 32 product groups enumerated in the Standard Industrial Classification ("SIC") Manual. Research expenses are not allocable solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are allocable to all the income within the SIC product group in which the product is classified. Accordingly, once a research expense is identified with a SIC product group, it is allocated to foreign sources based on the ratio of total foreign source sales receipts or income, as the case may be, within the SIC product group to the total worldwide sales receipts or income, as the case may be, within the SIC product group.

The regulation provides certain "safe harbors" when more than 50 percent of the research expenses are incurred either within or without the United States. For years beginning in 1979, the regulation allows a taxpayer to allocate 30 percent of the research expenses to the geographic source in which more than 50 percent of such expenses were incurred.

The regulation also provides that if the taxpayer's results of operations justify an allocation of research expenses to the country in which the research is performed that would be higher than the 30 percent allowed under this safe harbor rule, then the taxpayer may make such higher allocation. The remaining portion of the research expenses are then apportioned based upon the SIC formula.

Reasons for Change

The Congress believed that the portion of Treasury Reg. § 1.861–8 which relates to research expenses warrants further study because of its possible effect on U.S.-based research activities.

Taxpayers which are required to allocate research expenses for purposes of the foreign tax credit claim that more deductions must

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8489-91 (daily ed. July 27, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 243; H. Rep. No. 97-201 (July 24, 1981), pp. 130-131; H.R. 4242, as passed by the House (July 29, 1981), sec. 223; and H. Rep. No. 97-215 (August 1, 1981), pp. 224-225 (Joint Explanatory Statement of the Committee on Conference).

be allocated overseas than are allowed as deductions by the foreign country. Thus, taxpayers claim that their foreign tax credit limitation is lower than the foreign taxes paid and that they will lose foreign tax credits.

Because of the application of the regulation, taxpayers argue that they must transfer research activities to the foreign country in order to obtain a deduction in that country and thus obtain a full foreign tax credit on the income earned in that country. The Congress believed that the transfer of research activities overseas would not be in the best interest of the United States. Therefore, the Congress has concluded that the Treasury should study the impact of the allocation of research expenses under Reg. § 1.861-8 on U.S.-based research activities.

While that study is being conducted by the Treasury and considered by the Congress, the Congress believes that the expenses related to all research activities conducted in the United States should be charged to the cost of generating U.S. source income, whether or not such research directly or indirectly is a cost of producing foreign source income.

Explanation of Provision

For the taxpayer's first two taxable years beginning after the date of enactment of the Act, all research and experimental expenditures (within the meaning of sec. 174) which are paid or incurred in those taxable years (and only in those taxable years) for research activities conducted in the United States shall be allocated or apportioned to sources within the United States for all purposes under the Code.

The Treasury Department is directed under the Act to conduct a study of the impact that the research expenditure allocation provisions of Treasury Reg. § 1.861-8 has on research activities conducted in the United States and on the availability of the foreign tax credit. The study, with recommendations to the Congress, is to be submitted by the Secretary of the Treasury to the House Committee on Ways and Means and the Senate Committee on Finance not later than six months after enactment of the Act.

Effective Date

The requirement to allocate or apportion to U.S. sources those research and experimental expenditures which are attributable to research activities performed in the United States is effective for the first two taxable years of the taxpayer that begin after the date of enactment of the Act.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $57 million in 1982, $120 million in 1983, $62 million in 1984, and less than $5 million in 1985.

D. Small Business Provisions

1. Corporate tax rate reduction (sec. 231 of the Act and sec. 11 of the Code)*

Prior Law

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

The prior corporate taxable income brackets and tax rates are presented in the following table:

Taxable income:	*Tax rate*
0–$25,000	17
$25,000–$50,000	20
$50,000–$75,000	30
$75,000–$100,000	40
Over $100,000	46

This rate structure became effective for taxable years beginning after December 31, 1978.

Reasons for Change

During deliberations on the effects of inflation, the tax structure, and other relevant considerations affecting capital formation in the United States, the Congress reviewed a broad range of alternative general changes in the tax law. The Congress chose a combination of accelerated cost recovery and tax rate reduction intended to provide a stimulus to all business taxpayers. The corporate tax rate cuts were made to reduce the tax impact on the two lowest tax rate brackets because firms in these brackets tend to be smaller, often labor intensive firms, that will receive relatively smaller benefits from accelerated cost recovery.

Explanation of Provision

The Act reduces the tax rates for the two lowest corporate brackets, i.e., on taxable income below $50,000. This change will go into effect in 1982 and 1983.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7854-S7857 (daily ed. July 17, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 211; H. Rep. No. 97-201 (July 24, 1981), pp. 99-100; H.R. 4242, as passed by the House (July 29, 1981), sec. 231; and H. Rep. No. 97-215 (August 1, 1981), p. 231 (Joint Explanatory Statement of the Committee of Conference).

The corporate brackets below $50,000 are adjusted by the Act as follows:

Taxable income—	*Tax rate*
In 1982—	
Less than $25,000	16
$25,000–$50,000	19
1983 and later years—	
Less than $25,000	15
$25,000–$50,000	18

The Act also makes conforming amendments to tax rates imposed on certain mutual insurance companies (sec. 821).

Effective Date

The first reduction in the corporate tax rates applies to taxable years beginning after December 31, 1981. The second reduction applies to taxable years beginning after December 31, 1982. For fiscal year taxpayers, the benefit of the lower corporate rates apply to the parts of their fiscal years 1981–82 and 1982–83 that fall after December 31, 1981, and 1982, respectively (sec. 21).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $116 million in 1982, $365 million in 1983, $521 million in 1984, $565 million in 1985, and $610 million in 1986.

2. Increase in minimum accumulated earnings credit (sec. 232 of the Act and sec. 535 of the Code)*

Prior Law

In addition to the regular corporate income tax, an accumulated earnings tax of 27½ percent to 38½ percent is imposed on improperly accumulated corporate earnings if the accumulation occurs in an attempt to avoid the income tax with respect to the corporation's shareholders.

In computing the base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which were retained for the reasonable needs of the business. This is known as the "accumulated earnings credit." Prior law provided a minimum accumulated earnings credit of $150,000.

Reasons for Change

Since 1975, when the accumulated earnings credit was increased from $100,000 to $150,000, there have been substantial increases in the cost of capital investments. Increased borrowing costs have caused small businesses to rely more heavily on internal generation of capital for possible future needs. Quite often, small businesses do not have the specific plans for expansion which are required, under the law, to justify accumulations of corporate earnings in excess of the minimum credit.

The Congress believed that an increase in the credit would adjust for cost increases, and also provide a wider margin for future contingencies, thus reducing borrowing pressures on small businesses. However, the Congress also believed that the capital needs of service organizations are more limited and therefore the minimum credit provided by prior law for these corporations is adequate and should not be increased.

Explanation of Provision

The Act generally increases the minimum accumulated earnings credit to $250,000. However, this increase does not apply to service corporations the principal business of which consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 231; S. Rep. No. 97-144 (July 6, 1981), p. 90; H.R. 4242, as reported by the House Ways and Means Committee, sec. 231; H. Rep. No. 97-201 (July 24, 1981), pp. 101-102; H.R. 4242, as passed by the House (July 29, 1981), sec. 232; and H. Rep. No. 97-215 (August 1, 1981), p. 226 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision applies to taxable years beginning after December, 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $33 million in 1983, $36 million in 1984, $40 million in 1985, and $44 million in 1986.

3. Subchapter S corporations (secs. 233 and 234 of the Act and sec. 1371 of the Code)*

Prior Law

Subchapter S was enacted in 1958 to minimize the effect of Federal income taxes on the form in which a business is conducted, by permitting incorporation and operation of certain small businesses without incurring income taxation at both the corporate and shareholder levels.

If an eligible corporation elects under the subchapter S provisions, income or loss (except for certain capital gains) is not taxed to the corporation. Instead, each stockholder reports a share of the corporation's income or loss each year in proportion to the stockholder's interest in the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is revoked or terminated.

Under prior law, to be eligible for a subchapter S election, the corporation could not have had more than 15 shareholders. In addition, trusts other than grantor trusts, voting trusts, and certain testamentary trusts (for a 60-day or two-year period) could not be shareholders in a subchapter S corporation.

Reasons for Change

The Congress believed that increasing the permitted number of shareholders to 25 and allowing certain other types of trusts to be shareholders would facilitate use of the subchapter S provisions by more businesses.

Explanation of Provisions

Maximum number of shareholders

Under the Act, the maximum number of shareholders permitted for a corporation to qualify for, and maintain, subchapter S status is increased from 15 to 25 (sec. 1371(a)(1)).

Additional category of eligible trusts

The Act also allows a trust all of which is treated as owned by an individual (whether or not the grantor) who is a U.S. resident or citizen to hold stock in a subchapter S corporation (sec. 1371(e)(1)(A)).

Rules previously applicable to grantor trusts will also apply to trusts treated as owned by a person other than the grantor under

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 232, 233; S. Rep. No. 97-144 (July 6, 1981), p. 91; Senate floor amendment, 127 Cong. Rec. S8163 (daily ed. July 22, 1981); H.R. 4242, as reported by the House Ways and Means Committee, secs. 232-233; H. Rep. No. 97-201 (July 24, 1981), pp. 103-104; H.R. 4242, as passed by the House (July 29, 1981), secs. 233-234; and H. Rep. No. 97-215 (August 1, 1981), p. 226 (Joint Explanatory Statement of the Committee of Conference).

sec. 678. Thus, for example, the person treated as the owner (and not the trust) is treated as the shareholder for purposes of determining whether the corporation meets the subchapter S eligibility requirements. Also, if the trust continues in existence after the deemed owner's death, the trust continues to be eligible as a subchapter S shareholder for 60 days after the date of death (or for two years thereafter, if the entire corpus of the trust is included in the gross estate of the deemed owner).

Special rule for certain trusts

Under the Act, the individual income beneficiary of a "qualified subchapter S trust" may elect to be treated as the owner (under sec. 678) of stock in any subchapter S corporation held by the trust, and the trust will be an eligible shareholder of such corporation (sec. 1371(g)). The trust's portion of the undistributed taxable income of the corporation, as well as the taxable dividends received by the trust, will then be taxed to the electing beneficiary rather than the trust.

The election must be made by the beneficiary (or the beneficiary's legal representative) separately with respect to each subchapter S corporation whose stock is held by the trust. An election may be retroactive for a period of up to 60 days.

A qualified subchapter S trust means a trust (1) which holds stock of one or more subchapter S corporations; (2) all the income of which is distributed[1] currently to one individual (who must be a U.S. citizen or resident); and (3) under the terms of which (a) there may be only a single income beneficiary at any time, (b) any corpus distributed before the termination of the trust may be distributed only to the current income beneficiary, (c) each income interest shall terminate on the earlier of the death of the income beneficiary or the termination of the trust and, (d) on the termination of the trust during the life of an income beneficiary, the trust shall distribute all its assets to the income beneficiary.

The election to be treated as a qualified subchapter S trust is in addition to the election by the shareholders of the corporation to have the corporation treated as an electing small business corporation. If the trust is a shareholder at the time of making the subchapter S election, the income beneficiary must consent.

Effective Date

The provisions apply to taxable years beginning after December 31, 1981.

Revenue Effect

The provisions are estimated to reduce fiscal year budget receipts by less than $5 million annually.

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[1] This provision is intended to apply to a simple trust described in sec. 651(a), as well as to a trust which, for its taxable year, actually does distribute all its income (within the meaning of sec. 643(b)) currently although not required to do so by the terms of the trust.

4. LIFO inventory and small business accounting (secs. 235–238 of the Act and secs. 472 and 474 of the Code)*

Prior Law

Under the cash receipts and disbursements method of accounting, taxpayers may currently deduct all expenditures other than those for capital assets. However, if the production, purchase, or sale of merchandise is an income producing factor, the taxpayer must use the accrual method of accounting and must keep inventories. Acceptable methods of accounting for inventories include specific identification, average cost, first-in first-out, and last-in first-out ("LIFO").

An approved method of computing LIFO inventories is the dollar-value method. Dollar-value LIFO is an advantageous method of computing LIFO inventories. However, because of its inherent complexity, it is considered by some, especially small businessmen, as unworkable.

Under dollar-value LIFO, the taxpayer accounts for his inventory on the basis of a pool of dollars rather than on an item-by-item basis. In general, the pool of dollars is actually measured in terms of the equivalent dollar value of the inventory in the year the taxpayer first used the dollar-value LIFO method.

Reasons for Change

The Congress believed that the complexity associated with LIFO, and in particular dollar-value LIFO, has made the use of LIFO exceedingly difficult, especially for small business. Since LIFO is the current method of accounting for inventory that most effectively mitigates the effect of inflation on businesses engaged in the purchase and sale of merchandise the Congress believed that the LIFO method should be simplified and made more available to all taxpayers. Also, the Congress believed that other methods of accounting for inventories should be explored (including the cash receipts and disbursements method) in an effort to simplify and reform the methods of inventory accounting and to minimize income distortions resulting from inflation.

Explanation of Provisions

Under the Act, businesses with average annual gross receipts of less than $2 million for the three years ending with the taxable year may elect one inventory pool for purposes of dollar value LIFO inventory accounting. Also, taxpayers electing LIFO will

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8529 (daily ed., July 27, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 235; H. Rep. No. 97-201 (July 24, 1981), pp. 107-108; H.R. 4242, as passed by the House (July 29, 1981), secs. 235-238; and H. Rep. No. 97-215 (August 1, 1981), pp. 226-227 (Joint Explanatory Statement of the Committee of Conference).

have three years (beginning with the year of the election to LIFO) to take back into income inventory writedowns taken in years prior to the year of the LIFO election. The Treasury Department is to prescribe regulations providing for simplification of LIFO inventory accounting through the use of published government indexes.

Also under the Act, the Treasury is directed to conduct a full and complete study of methods of tax accounting for inventory (including, but not limited to, the LIFO method and the cash receipts and disbursements method) with a view toward the development of simplified methods. The Treasury is directed to submit to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate a report on this study, together with such recommendations as deemed appropriate, by December 31, 1982.

Effective Date

The provisions for three-year averaging of income relating to inventory writedowns taken in prior years and use of single dollar-value LIFO pools apply to taxable years beginning after December 31, 1981.

Revenue Effect

The provisions for three-year averaging of income relating to inventory writedowns taken in prior years and use of single dollar-value LIFO pools are estimated to reduce fiscal-year budget receipts by $68 million in 1982, $184 million in 1983, $192 million in 1984, $145 million in 1985, and $64 million in 1986.

E. Savings and Loan Associations

1. Reorganizations involving financially troubled thrift institutions (secs. 241–244 and 246 of the Act and secs. 362, 382 and 593 and new sec. 597 of the Code)*

Prior Law

Under a nonstatutory requirement applicable to tax-free mergers and other reorganizations (commonly called the "continuity of interest" requirement), shareholders of the acquired corporation must receive stock in the acquiring corporation. Under prior law, the application of this continuity of interest requirement to reorganizations involving a mutual thrift institution was unclear. Also, limitations are imposed on the use of pre-reorganization net operating loss carryovers if shareholders of the acquired corporation are not shareholders of the surviving corporation in a merger or other reorganization (sec. 382).

Distributions out of excess bad debt reserves of building and loan associations are recaptured as ordinary income (sec. 593(e)). Contributions to capital by nonshareholders are excluded from the income of a recipient corporation (sec. 118), but the basis of property is reduced by such contributions (sec. 362(c)).

Reasons for Change

The Congress believed that recent economic conditions, including high interest rates, have had particularly adverse effects on the country's thrift institutions, which have been the primary providers of mortgage credit. These thrift institutions traditionally have engaged in short-term borrowing from their depositors, while lending on a long-term basis to their mortgagors. The recent high interest rates have required the thrift industry to pay high short-term rates to depositors; at the same time, substantial portions of mortgage portfolios consist of mortgages paying much lower rates. The resulting losses have threatened the viability of thrift institutions.

In many cases, the Federal Savings and Loan Insurance Corporation (FSLIC) is able to help maintain financially troubled thrift institutions through contributions of funds to an institution. The repayment of these contributions may be contingent on subsequent profitability of the institution. In other cases, the only way to maintain these organizations may be to merge financially troubled institutions into stronger institutions. In many of these reorganizations, the FSLIC contributes money to the acquiring organization as an inducement to merge with the financially troubled institution.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8287–88 (daily ed. July 23, 1981); H.R. 4242, as passed by the House (July 29, 1981), secs. 241–245; and H. Rep. No. 97-215 (August 1, 1981), pp. 283–84 (Joint Explanatory Statement of the Committee of Conference).

The Congress concluded that the tax laws should be modified to facilitate providing of financial assistance by the FSLIC and mergers of financially troubled institutions into stronger institutions. Specifically, the Congress believed that the merger of financially troubled institutions into stronger organizations should be allowed without regard to the continuity of interest rules. Without tax-free reorganization treatment, the basis of mortgages in the hands of the acquiring organization would be a cost basis; since this basis typically would be substantially below face value where interest rates have risen, repayments of principal would result in taxable income to the acquiring corporation.

In addition, the Congress concluded that contributions by the FSLIC to either a financially troubled thrift institution or to an organization merging with a financially troubled thrift institution should not be treated as income. Similarly, if amounts are repaid to the FSLIC, repayments of principal should not be subject to recapture rules (sec. 593(e)). However, the Congress believed that the recapture rules should apply to the payment of any interest or dividends to the FSLIC on such contributions.

Explanation of Provisions

Tax-free reorganizations

The Act allows tax-free reorganizations of thrift institutions undertaken in connection with a case under the jurisdiction of the Federal Home Loan Bank Board or Federal Savings and Loan Insurance Corporation (or, if neither has supervisory authority, an equivalent state authority) without regard to the "continuity of interest" requirement. Institutions to which this rule applies are building and loan associations, cooperative banks, and mutual savings banks (i.e., thrift institutions to which sec. 593 applies).

The provision covers all possible combinations of stock and mutual thrift institutions, i.e., stock acquiring mutual, stock acquiring stock, mutual acquiring mutual, and mutual acquiring stock. The provision applies to these combinations only if the appropriate agency certifies to the existence of one of the grounds in 12 U.S. Code §§ 1464(d)(6)(A) (i), (ii), or (iii). The Congress understands, and it is intended, that no certification will be made by the appropriate agency on the grounds set forth in 12 U.S. Code §§ 1464(d)(6)(A) (ii) or (iii) unless it is determined that the transferor is unable to meet its obligations as they become due or will be unable to do so in the immediate future,[1] and that no certification will be made by the appropriate agency if it is determined that the association has intentionally placed itself in the position where one of the grounds for certification would apply.

The provision requires that substantially all the assets of the transferor must be acquired by the transferee and that substantially all of the liabilities of the transferor, including deposits, immediately before the transfer must become liabilities of the transferee. The provision removes the requirement that stock or securities in the transferee corporation must be received or distributed in the

[1] Notwithstanding the fact that the appropriate agency may make a certification required by the provision only on the grounds that the institution cannot, or will not be able to, meet its obligations, the appropriate agency may nevertheless appoint a receiver on any of the grounds set forth in 12 U.S.C. §§1464(d)(6)(A) (ii) or (iii).

transaction. No inference is intended by the provision concerning the proper tax treatment of supervisory mergers under prior law or concerning the extent to which the continuity of interest requirement is to be considered satisfied in acquisitions outside the scope of the provision.

The Act provides that, in applying section 382(b) to operating loss carryovers to the surviving corporation after a reorganization of a thrift institution which has been certified by the appropriate agency as described above, deposits in the acquired corporation which become deposits in the transferee are treated as stock of both corporations. Deposits in the transferee are also treated as stock for this purpose. It is intended that section 269 is to apply as under current law to reorganizations covered by the provision. Also, it is intended that, in applying section 269 to such acquisitions, depositors in a thrift institution to which section 593 applies are to be treated as shareholders and deposits in the institution are to be treated as stock.

Recapture rule; FSLIC

Under the Act, the recapture rule for distributions out of excess bad debt reserves (sec. 593(e)) does not apply to distributions to the Federal Savings and Loan Insurance Corporation in redemption of an interest in a thrift institution received in exchange for financial assistance. This treatment does not extend to any distributions not in redemption. Thus, the exclusion does not apply to payments of interest to the Federal Savings and Loan Insurance Corporation by the thrift institution. The exclusion from recapture applies whether or not the interest may be treated as an equity interest under applicable tax law rules.

The Act excludes from income of a building and loan association all money or property contributed to the building and loan association by the Federal Savings and Loan Insurance Corporation under its financial assistance program without reduction in basis of property. The provision applies to assistance payments whether or not the association issues either a debt or equity instrument in exchange therefore. No inference is intended as to the proper treatment of Federal Savings and Loan Insurance Corporation assistance payments under prior law with respect to whether such payments are excluded from income or require a basis reduction.

Effective Date

These provisions apply to transfers in reorganization, distributions by building and loan associations, and payments by the Federal Savings and Loan Insurance Corporation on or after January 1, 1981.

Revenue Effect

These provisions (secs. 241–244 of the Act) are estimated to reduce fiscal year budget receipts by less than $5 million annually.[2]

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[2] This estimate is based on limited information about such reorganizations that were planned without this provision. If such reorganizations would have increased markedly without this provision, the revenue loss could be substantial.

2. Tax treatment of mutual savings banks that convert to stock associations (secs. 245 and 246 of the Act and secs. 591 and 593 of the Code)*

Prior Law

Building and loan associations, cooperative banks, and nonstock mutual savings banks compute bad debt deductions under a special set of rules (sec. 593).

Under one of these rules, called "the percent of taxable income method", these institutions are allowed a bad debt deduction equal to 40 percent of their taxable income (computed without regard to the bad debt deduction). However, to qualify for the full amount of this deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in certain assets (hereafter called "qualified assets"). The 40 percent is reduced under a formula to the extent that the percentage of qualified assets is less than the 82- or 72-percent levels. The reduction in the case of building and loan associations and cooperative banks is three-fourths of one percent for each percentage point that the percent of qualified assets is less than 82 percent of all assets. The reduction in the case of mutual savings banks is 1½ percent for each percentage point that the percent of qualified assets in less than 72 percent of all assets.

The tax law also provides rules which recapture excess bad debt deductions of building and loan associations when there are dividends in excess of post-1951 earnings and profits or when there are liquidations or redemptions of stock (sec. 593(e)).

Under prior law, these special provisions applicable to mutual savings banks, etc. did not apply to stock savings banks.

Reasons for Change

A number of States have recently enacted legislation which permits mutually organized savings banks to reorganize as stock organizations. The special provisions of the Code applicable to thrift institutions under prior law were drafted when stock savings banks could not be created under applicable State law and, consequently, those provisions did not apply to stock savings banks. As a result, a mutual savings bank that reorganized into a stock savings bank would lose the special tax benefits applicable to mutual savings banks.

The Congress believed that a State policy of permitting mutually organized savings banks to reorganize into stock organizations should not be frustrated by the provisions of the Code. Accordingly, the Congress concluded that provisions applicable to thrift institu-

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8471–72 (daily ed. July 27, 1981), and H. Rep. No. 97–215 (August 1, 1981), pp. 284–85 (Joint Explanatory Statement of the Committee of Conference).

tions should be modified to facilitate the conversion of mutual savings banks into stock savings banks. However, the Congress believed that stock savings banks more closely resemble building and loan associations than mutual savings banks. Therefore, the Congress concluded that stock savings banks should be subject to the same rules applicable to building and loan associations.

Explanation of Provision

The Act makes two changes to prior tax law intended to facilitate the conversion of mutual savings banks into stock associations. These provisions apply to both mutual savings banks which convert into stock associations and to newly formed stock associations so long as the institution is operated as a savings institution and is subject to the same Federal or State regulatory scheme as a mutual savings bank chartered under Federal or State law.

First, the Act provides that a stock association which is subject to the same regulation as a mutual savings bank is to be treated as a mutual savings bank, and thus is eligible to compute its bad debt deduction under section 593. However, consistent with the treatment of building and loan associations which may be organized as stock associations, such stock associations must compute their bad debt deduction under the percentage of eligible loan method under the same rules applicable to building and loan associations (i.e., 82 percent of their assets must be invested in qualified assets in order to receive the full 40-percent deduction and the reduction will be at three-fourths of one percent rate). Similarly, the Act requires recapture of excess bad debt deductions by such stock associations in the same manner as building and loan associations (sec. 593(e)).

Second, the Act clarifies that amounts paid to depositors of such stock associations are deductible to the same extent as mutual savings banks (sec. 591).

Effective Date

The provision applies to taxable years ending after the date of enactment.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $5 million in 1981, $10 million in 1982, $12 million in 1983, $18 million in 1984, $22 million in 1985, and $25 million in 1986.

F. Stock Options, Etc.

1. Incentive stock options (sec. 251 of the Act and new sec. 422A of the Code)*

Prior Law

Tax treatment under section 83

Under prior law, the tax treatment of employee stock options generally was governed by section 83 and the regulations thereunder (Treas. Reg. § 1.83-7).

Under those rules, the value of a stock option constituted ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at that time. If the option did not have a readily ascertainable value when granted, it did not constitute ordinary income at that time.[1] Instead, when the option was exercised, the difference between the value of the stock at exercise and the option price constituted ordinary income to the employee. Ordinary income on grant or on exercise of a stock option was treated as personal service income and, hence, generally was taxed at a maximum rate of 50 percent.

An employer who granted a stock option generally was allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

Background—certain employee stock options

Restricted stock options

The Revenue Act of 1950 enacted provisions for "restricted stock options," under which neither grant nor exercise of the option gave rise to income to the employee. Instead, income generally was recognized when the employee sold stock received through exercise of the option. No deduction was allowed to the employer with respect to the amount of income recognized by the employee (the gain on sale of the stock).

If the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time the stock was sold was treated as capital gain. If the option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the market value of stock at the time of the

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 251; S. Rep. No. 97-144 (July 6, 1981), pp. 97-101; Senate floor amendment, 127 Cong. Rec. S8730-31 (daily ed. July 29, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 801; H. Rep. No. 97-201 (July 24, 1981), pp. 259-262; H.R. 4242, as passed by the House (July 29, 1981), sec. 251; and H. Rep. No. 97-215 (August 1, 1981), pp. 231-236 (Joint Explanatory Statement of the Committee of Conference).

[1] Section 83 does not apply to the transfer of an option without a readily ascertainable fair market value (sec. 83(e)(3)). Treas. Reg. § 1.83-7(a) implies that no income is realized upon grant of such an option.

option grant and the option price was treated as ordinary income when the stock was sold and any additional gain at the time the stock was sold was treated as capital gain.

For a stock option to be classifed as "restricted," the option price had to have been at least 85 percent of the market price of the stock at the time the option was granted; the stock or the option had to have been held by the employee for at least two years after the date of the granting of the option, and the stock held for at least six months after it was transferred to the employee; the option could not have been transferable other than at death; the individual could not have held ten percent or more of the stock of the corporation (unless the option price was at least 110 percent of the fair market value); and the option could not have been for a period of more than ten years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock option provisions and enacted provisions for "qualified stock options." These qualified stock options generally were taxed similarly to restricted stock options.

Qualified options had to be granted with an option price of at least the stock's market price when the option was granted (subject to a 150-percent inclusion in income if a good faith attempt to meet this requirement failed). In addition, qualified stock options were subject to the requirements that the stock had to be held three years or more; the option could not be held more than five years; stockholder approval had to be obtained; the options had to be exercised in the order granted; and no option could be granted to shareholders owning more than five percent of the stock (increased up to ten percent for corporations with less than $2 million equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 enacted a minimum tax, under which a tax was imposed equal to ten percent of the items of tax preference (reduced by an exemption of $30,000 and by regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added by the 1969 Act. Income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976 (except for certain transitional options which ceased to be qualified after May 20, 1981). The 1976 Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax, and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978—Treatment of capital gains

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, taxes on capital gains were reduced, so that the maximum rate of tax on capital gains is 28 percent.

Reasons for Change

The Congress believed that reinstitution of a stock option provision will provide an important incentive device for corporations to attract new management and to retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of a business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies involved. The provision is designed to encourage the use of stock options for key employees without reinstituting the alleged abuses which arose with the restricted stock option provisions of prior law.

Explanation of Provision

In general

The Act provides for "incentive stock options," which are taxed in a manner similar to the tax treatment previously applied to restricted and qualified stock options.[2] That is, there are no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee generally is taxed at capital gains rates when the stock received on exercise of the option is sold. Similarly, no business expense deduction is allowed to the employer with respect to an incentive stock option (sec. 421(a)).

Requirements to receive special tax treatment

The Act provides that the employee, in order to receive special treatment under section 421(a), must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, tax is deferred until disposition of the stock, but gain (to the extent the value of the stock at exercise of the option exceeds the exercise price) is treated as ordinary income rather than capital gain, and the employer is allowed a deduction at that time.[3]

In addition, for the entire time from the date of granting the option until three months [4] before the date of exercise, the option

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[2] In general, to the extent that provisions of prior law have been included in the incentive stock option provisions, interpretations of prior law are to apply to incentive stock options.

[3] Sec. 421(b) and Regs. §§ 1.421-5(e) and 1.421-8(b)(1). In the case of certain dispositions where the amount realized on disposition is less than the stock's value at exercise and which do not meet the holding period requirements, the amount of ordinary income, and the amount of the employer's deduction, are limited to the difference between the amount realized on the sale and the option price (sec. 422A(c)(2)). This rule is intended to apply in the case of a failure to meet either the one-year or the two-year holding period requirements of sec. 422A(a)(1).

[4] Twelve months if the employee is disabled within the meaning of sec. 105(d)(4) when he or she leaves employment (sec. 422A(c)(9)).

holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirements are waived in the case of death of the employee.[5]

Definition of "incentive stock option"

For an option to qualify as an "incentive stock option," the following conditions must be met:

(1) The option must be granted under a plan specifying the aggregate number of shares of stock which may be issued and the employees or class of employees eligible to receive the options. This plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted.[6]

(2) The option must be granted within ten years from the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.[6]

(3) The option must by its terms be exercisable only within ten years of the date it is granted.[7]

(4) The option price must equal or exceed the fair market value of the stock at the time the option is granted.[6] This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.[8]

(5) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.[6, 7]

(6) The employee must not, at the time the option is granted, own[9] stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary.[7] However, the stock ownership limitation will not apply if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.[7]

(7) The option by its terms is not exercisable while there is outstanding any incentive stock option which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding until the expiration of the period which under its initial terms it could have been exer-

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[5] Sec. 421(c)(1). For purposes of the holding period requirements, the Act also provides that certain transfers by an insolvent individual of stock received pursuant to exercise of an incentive stock option are not to be treated as dispositions of such stock. The transfers covered by this rule are transfers to a trustee, receiver, or similar fiduciary, or other transfers for the benefit of the individual's creditors, in a bankruptcy case or similar insolvency proceeding (sec. 422A(c)(3)).

[6] This requirement is the same as a requirement of the qualified stock option provisions (sec. 422(b)).

[7] This requirement is the same as a requirement of the restricted stock option provisions (sec. 424(b)).

[8] The determination of whether a "good faith" attempt was made is to be in accordance with the rules under section 422(c)(1) and Treas. Reg. § 1.422-2(e)(2)(ii).

[9] For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, spouse, ancestors, and lineal descendants. Stock owned directly or indirectly by a corporation, partnership, estate, or trust is considered as being owned proportionately by shareholders, partners, or beneficiaries (sec. 425(d)).

cised.[6, 10] Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner.

(8) In the case of options granted after 1980, the terms of the plan must limit the amount of aggregate fair market value of the stock (determined at the time of the grant of the option) for which any employee may be granted incentive stock options in any calendar year to not more than $100,000 plus the carryover amount. The carryover amount for an employee from any year after 1980 is one-half of the amount by which $100,000 exceeds the value at time of grant of the stock for which incentive stock options were granted in such prior year. Amounts may be carried over three years. Options granted in any year use up the $100,000 current year limitation first and then the carryover amount from earliest year.[11]

Amounts may be carried over from an earlier calendar year whether or not the corporation had an option plan in effect for the earlier year. However, an employee must have been employed by the corporation (or subsidiary, parent, or predecessor corporation) for some part of the earlier year.

Additional rules

The Act provides that stock acquired on exercise of an incentive stock option may be paid for with stock of the corporation granting the option (sec. 422A(c)(5)(A)).

The difference between the option price and the fair market value of the stock at the exercise of an incentive stock option is not an item of tax preference.

Also, under the Act, an option which was a qualified stock option or restricted stock option under prior law and which was not exercised before January 1, 1981 is treated as an incentive stock option if both (1) the employer elects to have the option so treated (subject to the transitional rule dollar limitations) and also (2) the option otherwise satisfies the requirements for incentive stock options.[12] The price spread on such an option is not an item of tax preference.

The Act also provides that the employee may have the right to receive additional compensation (in cash or other property) at the time of exercise of the option so long as the additional amount is includible in income under the provisions of sections 61 and 83. Thus, the employer corporation may pay the employee additional amounts (whether or not the amount of additional compensation is determined by reference to the price of the stock and/or the option price) when the employee exercises the option (sec. 422(c)(5)(B)).

An incentive stock option will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements. For example, a transfer of shares (for local law

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[10] Unlike the qualified stock option provisions, there is no rule similar to sec. 422(c)(6), allowing an option to be exercisable when there is outstanding, a lower-priced, earlier-granted option.

[11] It is intended that this limit is to apply only to incentive stock options and that nonqualified options under a plan will not count against the $100,000.

[12] Generally, qualified stock options will meet all incentive stock option requirements other than the sequencing provisions of sec. 422A(b)(7). The failure to meet the sequencing provision is caused by the absence of a provision, similar to sec. 422(c)(6), allowing the exercise of a later granted, higher priced option. However, the earliest issued incentive stock options need not contain a sequencing rule. See Treas. Reg. § 1.422-2(f)(1)(iii) and Rev. Rul. 67-166, 1967-1 C. B. 97, for a similar rule with respect to qualified stock options.

purposes) of stock to an employee in exchange for a nonrecourse note does not disqualify a plan if the arrangement constitutes the grant of an option for Federal tax purposes. (Regs. §§ 1.83-3(a) and 1.421-7(a) contain rules relating to the definition of "option" and rules setting forth when a "transfer" of property as compensation for services occurs.)

Further, an employee's right to receive a taxable payment of cash or other property (including employer stock) in an amount equal to the difference between the then fair market value of the stock and the exercise price in exchange for the cancellation or surrender of the option (at a time when it is otherwise exercisable) does not disqualify the option. This applies where the exercise of this right has the same economic and tax consequences as the exercise of the option followed by an immediate sale of the stock to the employer (which would be taxed as ordinary income under section 421(b)). It is intended that the option be treated as exercised for purposes of applying the sequencing provisions of section 422A(b)(7).

However, alternative rights which have the effect of causing an option to fail to meet the requirements of section 422A(b), such as by extending the option term beyond ten years, setting a price below fair market value, permitting transferability, or allowing nonsequential exercise, will prevent an option from qualifying as an incentive stock option. See Rev. Rul. 73-26, 1973-1 C.B. 204, as modified by Rev. Rul. 73-330, 1973-2 C.B. 426.

Finally, the Act provides that corporate employers are to inform the employee of the transfer pursuant to the exercise of an incentive stock option (sec. 6039(a)(1)).

Effective Date

The provision applies to options originally granted on or after January 1, 1976.

In the case of an option granted during the years 1976 through 1980, the provision applies only if (1) the option was outstanding on January 1, 1981, and (2) the employer elects (in such manner as the Treasury Department provides) to have the option treated as an incentive stock option. The aggregate value (determined at time of grant) of stock for which an employee may be granted incentive stock options prior to 1981 may not exceed $50,000 per calendar year and $200,000 in the aggregate for the five-year period 1976-1980. The election may be made with respect to those options which the employer selects. The taxation of options with respect to which no election is made will not be affected.

In the case of an option granted on or after January 1, 1976, and outstanding on August 13, 1981, the option terms (or the terms of the plan under which the option was granted) may be changed, or shareholder approval obtained,[13] to conform to the incentive stock option rules, by August 13, 1982, without the change giving rise to

[13] If timely approval of the plan was previously made by the shareholders, no further approval is necessary unless a change is made in the class of employees or the aggregate number of shares permitted under the plan. If the plan had not been timely approved, approval between August 13, 1981 and August 13, 1982, will allow those options outstanding on August 13, 1981, to qualify as incentive stock options. See Treas. Reg. § 1.422-2(b) for rules relating to approval of a plan.

a new option requiring the setting of an option price based on a later valuation date.

All such changes relate back to the time of granting the original option. For example, if the option price of a ten-year option granted in 1978 is increased during the one year after date of enactment to 100 percent (110 percent, if applicable) of the fair market value of the stock on the date the option was granted in 1978, the price requirement will be met. Likewise, if the term of an option held by a ten-percent shareholder is shortened to five years from the date the option was granted, the ten-percent stock ownership limitation will not apply.

Any option must meet the incentive stock option requirements of section 422A(b) at the time it is exercised to receive incentive stock option treatment, although the employer election with respect to pre-1981 options may be made after an option is exercised and timely shareholder approval may be obtained after exercise of an option.

Revenue Effect

The provisions on incentive stock options (sec. 251 of the Act) and on property transferred to employees subject to certain restrictions (sec. 252 of the Act) are estimated to reduce fiscal year budget receipts, in the aggregate, by less than $5 million annually in 1981–1984, and to increase fiscal year budget receipts, in the aggregate, by $11 million in 1985 and $21 million in 1986.

2. Property transferred to employees subject to certain restrictions (sec. 252 of the Act and sec. 83 of the Code)*

Prior Law

The taxation of property transferred by an employer to an employee as compensation is governed by Code section 83.

Generally, if property (including stock) received is not transferable or is subject to a substantial risk of forfeiture (such as the obligation to perform future services), taxation is postponed until the stock or the property is transferable or is no longer subject to a substantial risk of forfeiture. The U.S. Tax Court has ruled[1] that section 16(b) of the Securities Exchange Act of 1934,[2] under which an "insider's" profit may be recovered by a corporation if the stock is sold within six months of receipt, does not make the stock nontransferable, and therefore does not affect the taxation of the stock. Thus, under prior law, the value of the stock (less any amount paid) was treated as compensation when received.

An employer generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

Reasons for Change

The Congress believed that the imposition of Federal restrictions which limit the ability of an "insider" to dispose of stock for a six-month period of time after receipt should be taken into account in determining the manner in which the value of the stock is included in income. Because of mandated restrictions on transferability, the Congress believes it may be inequitable to tax the employee before the end of this six-month period.

Explanation of Provision

Under the provision, stock received by a taxpayer which is subject to the application of section 16(b) of the Securities Exchange Act of 1934 is treated as being nontransferable and subject to a substantial risk of forfeiture for the six-month period following receipt of the stock during which that section applies. Thus, at the expiration of the six-month period, the employee must include in income, and the employer may deduct, the difference between the value of the stock at that time and the amount paid (if any). However, an employee may elect (under sec. 83(b)) to include in income, at the time of the transfer, the excess of the value of the

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 810; H. Rep. No. 97-201 (July 24, 1981), pp. 263-264; H.R. 4242, as passed by the House (July 29, 1981), sec. 808; and H. Rep. No. 97-215 (August 1, 1981), pp. 285-286 (Joint Explanatory Statement of the Committee of Conference).

[1] *Horwith* v. *Comm'r*, 71 T.C. 932 (1979).

[2] 15 U.S.C. § 78p(b).

property at that time (determined without regard to the section 16(b) restriction) over any amount paid.

A similar rule is applicable if stock is subject to a restriction on transfer by reason of the need to comply with the "pooling-of-interests accounting" rules set forth in Accounting Series Releases Numbered 130 ((10/5/72) 37 FR 20937; 17 CFR 211.130) and 135 ((1/18/73) 38 FR 1734; CFR 211.135).

Effective Date

The provision applies to taxable years (of the transferee) ending after December 31, 1981.

Revenue Effect

The provisions on incentive stock options (sec. 251 of the Act) and on property transferred to employees subject to certain restrictions (sec. 252 of the Act) are estimated to reduce fiscal year budget receipts, in the aggregate, by less than $5 million annually in 1981–1984, and to increase fiscal year budget receipts, in the aggregate, by $11 million in 1985 and $21 million in 1986.

G. Miscellaneous Provisions

1. Extension and revision of targeted jobs credit; termination of WIN credit (sec. 261 of the Act and secs. 51 and 50B of the Code)*

Prior Law

Targeted jobs tax credit

General rules

The targeted jobs credit, which under prior law applied to eligible wages paid before January 1, 1982, was available on an elective basis for hiring individuals from one or more of seven target groups. The credit is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages paid to a target group individual.

Qualified first-year wages are wages paid for services during the one-year period which begins with the day the individual first begins working for the employer. However, in the case of a vocational rehabilitation referral, this period begins with the day the individual starts work for the employer that is on or after the beginning of the individual's rehabilitation plan. Qualified second-year wages are wages attributable to services rendered during the one-year period immediately following the close of the first one-year period.

Since no more than $6,000 of wages during either the first or second year of employment may be taken into account with respect to any individual, the maximum credit per individual is $3,000 in the first year of employment and $1,500 in the second year of employment. The employer's deduction for wages is reduced by the amount of the credit (determined without regard to the tax liability limitation on the credit). Thus, for an employer who hires an eligible employee who earns $6,000 in the first year of employment, the credit results in an actual tax reduction that ranges from $900 (for an employer in the 70-percent bracket) to $2,580 (for an employer in the 14-percent bracket). However, because all wages are deductible for employees who are not members of target groups, after-tax costs of the first $6,000 of wages paid to an employee would range from $1,800 (for an employer in the 70-percent bracket) to $5,160 (for an employer in the 14-percent bracket) if the credit were not available. Thus, the credit provides a 50-percent reduction in the after-tax costs of the first $6,000 of wages paid to target group employees in the first year of employment, regardless of the employer's tax bracket.

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*For legislative background of the provision, see Senate floor amendment, 127 Cong. Rec. S8242-8250 (daily ed. July 23, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 804; H. Rep. No. 97-201 (July 24, 1981), pp. 274-81; H.R. 4242, as passed by the House (July 29, 1981), sec. 804; and H. Rep. No. 97-215 (August 1, 1981) pp. 236-237 (Joint Explanatory Statement of the Committee of Conference).

Target groups

The targeted jobs tax credit was available only with respect to the hiring of individuals who are members of one of seven target groups.

The statute contains certification provisions which relieve the employer of responsibility for proving to the Internal Revenue Service that an individual is a member of a target group. The Secretaries of Treasury and Labor were required jointly to designate a single employment agency in each locality to make this determination and to issue a certificate which, without further investigation on the part of the employer, is sufficient evidence that the individual is a member of such group. An exception to this procedure is made for cooperative education students, whose eligibility is certified by the qualified school participating in the program.

The seven target groups provided for in prior law are described in the following discussion.

(1) Vocational rehabilitation referrals

Vocational rehabilitation referrals are individuals who have a physical or mental disability constituting a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973, or under a rehabilitation plan for veterans carried out under 38 U.S. Code, chapter 31.

(2) Economically disadvantaged youths

Economically disadvantaged youths are individuals who are at least age 18, but not older than 25, on the date hired and who are members of economically disadvantaged families (which were families with income, during the preceding six months, which on an annual basis would be less than 70 percent of the Bureau of Labor Statistics lower living standard as determined by the designated local employment agency).

(3) Economically disadvantaged Vietnam-era veterans

The third target group consisted of Vietnam-era veterans who are certified by the designated local employment agency as under 35 on the date hired and who are members of economically disadvantaged families. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as discussed above.

A Vietnam-era veteran is an individual who has served on active duty (other than for training) in the Armed Forces more than 180 days, or who has been discharged or released from active duty in the Armed Forces for a service-connected disability, but in either case the active duty must have taken place after August 4, 1964 and before May 8, 1975. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending

on the date the individual is hired by the employer. This latter rule is intended to prevent employers who hire current members of the Armed Services (or those recently departed from service) from receiving the credit.

(4) SSI recipients

SSI recipients are individuals receiving Supplemental Security Income under Title XVI of the Social Security Act including State supplements described in section 1616 of that Act or section 212 of P.L. 93-66. To be an eligible employee, the individual must have received SSI payments during a month ending during the 60-day period which ends on the date the individual is hired by the employer.

(5) General assistance recipients

General assistance recipients are individuals who receive general assistance for a period of not less than 30 days if this period ends within the 60-day period ending on the date the individual is hired by the employer. General assistance programs are State and local programs which provide individuals with money payments based on need. These programs are referred to by a wide variety of names, including home relief, poor relief, temporary relief, and direct relief.

Examples of individuals who may receive money payments from general assistance include those ineligible for a Federal program, or waiting to be certified by such a program, unemployed individuals not eligible for unemployment insurance, and incapacitated or temporarily disabled individuals. Some general assistance programs provide grants to individuals who find themselves in a one-time emergency situation; however, many of these families will not meet the "30-day requirement" described above.

Because of the wide variety of such programs, the law provides that a recipient will be an eligible employee only after the program has been designated by the Secretary of the Treasury, after consultation with the Secretary of Health and Human Services, as a program which provides cash payments to needy individuals.

(6) Cooperative education students

The sixth target group consisted of youths who actively participate in qualified cooperative education programs, who have attained age 16 but who have not attained age 20, and who have not graduated from high school or vocational school.

The definitions of a qualified cooperative education program and a qualified school are similar to those used in the Vocational Education Act of 1963. Thus, a qualified cooperative education program means a program of vocational education for individuals who, through written cooperative arrangements between a qualified school and one or more employers, receive instruction, including required academic instruction, by alternation of study in school with a job in any occupational field, but only if these two experiences are planned and supervised by the school and the employer so that each experience contributes to the student's education and employability.

For this purpose, a qualified school is (1) a specialized high school used exclusively or principally for the provision of vocational education to individuals who are available for study in preparation for entering the labor market, (2) the department of a high school used exclusively or principally for providing vocational education to persons who are available for study in preparation for entering the labor market, or (3) a technical or vocational school used exclusively or principally for the provision of vocational education to persons who have completed or left high school and who are available for study in preparation for entering the labor market. In order for a nonpublic school to be a qualified school, it must be exempt from income tax under Code section 501(a).

(7) Economically disadvantaged former convict

An individual who is certified by the designated local employment agency as having at some time been convicted of a felony under State or Federal law and who is a member of an economically disadvantaged family is an eligible employee for purposes of the targeted jobs credit, if the individual is hired within five years of the later of release from prison or date of conviction. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as those discussed above.

Limitations on amount of credit

Wages may be taken into account for purposes of the credit only if more than one-half of the wages paid during the taxable year to the employee are for services in the employer's trade or business. In addition, wages for purposes of the credit do not include amounts paid to an individual for whom the employer is receiving payments for on-the-job training under Federally funded programs, such as the Comprehensive Employment and Training Act (CETA). Moreover, the employer could not claim the targeted jobs credit for wages paid to an individual with respect to whom a WIN credit is claimed.

Qualified first-wages for all targeted employees could not exceed 30 percent of FUTA wages for all employees during the calendar year ending in the current tax year.

Also, in order to prevent taxpayers from eliminating all tax liability by reason of the credit, the credit may not exceed 90 percent of the employer's tax liability after being reduced by all other nonrefundable credits, except the residential energy credit (sec. 44C), the credit for producing fuel from a non-conventional source (sec. 44D), and the alcohol fuel credit (sec. 44E). Unused credits may be carried back three years and carried forward seven years.

Special rules

For purposes of determining the years of employment of an employee, wages up to $6,000, and the 30-percent FUTA cap, all employees of all corporations that are members of a controlled group of corporations are treated as if they are employees of the same corporation. Under the controlled group rules, the amount of credit allowed to the group is generally the same which would be

allowed if the group were a single company. Comparable rules are provided for partnerships, proprietorships, and other trades or businesses (whether or not incorporated) that are under common control. Thus, all employees of these organizations generally are treated as if they are employed by a single person. The amount of targeted jobs credit available to each member of a controlled group is each member's proportionate share of the wages giving rise to the credit.

The targeted jobs tax credit may be used as an offset against the alternative minimum tax except to the extent that the minimum tax is attributable to net capital gains and adjusted itemized deductions.

WIN tax credit

General rules

For trade or business employment, prior law provided a WIN tax credit equal to 50 percent of qualified first-year wages and 25 percent of qualified second-year wages paid to WIN registrants and AFDC recipients. For employment other than in a trade or business, the credit was 35 percent of qualified first-year wages.

No more than $6,000 of wages during either the first or second year could be taken into account with respect to any individual. Thus, the maximum credit per individual employed in a trade or business was $3,000 in the first year of employment and $1,500 in the second year of employment. The employer's deduction for wages was reduced by the amount of the credit.

Eligible employees

An eligible employee was an employee who either was a member of an AFDC (Aid to Families with Dependent Children) family that had been receiving AFDC for at least 90 continuous days preceding the date of hiring or was placed in employment under the WIN program. In addition, for the credit to be available, the employee must have been employed by the taxpayer for more than 30 consecutive days on a substantially full-time basis, or, in the case of an employee whose employment is related to providing child day care services, on a full-time or part-time basis.

No credit was available in the case of: expenses reimbursed, for example, by a grant; employees who displace other employees from employment; migrant workers; or employees who are close relatives, dependents, or major stockholders of the employer.

Limitations on amount of credit

The WIN-welfare recipient tax credit could not exceed 100 percent of tax liability. Unused credits could be carried back three years and carried forward seven years.

In the case of non-trade or business wages, the maximum amount of creditable wages was $12,000. In effect, this permitted a taxpayer to claim the credit for up to two full-time nonbusiness employees.

The credit for dependent care expenses (sec. 44A) could not be claimed with respect to any wages for which the taxpayer was allowed a WIN-welfare recipient credit.

Special rules

The WIN-welfare recipient credit contained rules similar to those applicable in the case of the targeted jobs credit for controlled groups. Thus, the amount of credit allowable to each member of a controlled group was the member's share of wages giving rise to the credit.

The WIN credit could be used as an offset against the alternative minimum tax, except to the extent that the alternative minimum tax was attributable to net capital gains and adjusted itemized deductions, to the extent the credit was attributable to the active conduct of a trade or business by the taxpayer claiming the credit.

Reasons for Change

The Congress believed that experience with the targeted jobs credit since its enactment in 1978 has been sufficiently promising to warrant an extension. At the same time, several shortcomings had become apparent and are corrected in the Act.

First, the Congress believed that the credit should be extended for one year, so that all employees who begin work for the employer before 1983 will be eligible for a full two years of credit.

Second, the Congress was concerned about the extent to which the credit was being claimed for employees with retroactive certifications, i.e., for employees hired before the employer knew such individuals were members of target groups. Clearly, in these cases, the credit was not serving as an incentive for the hiring of target group members. Accordingly, the Act requires that certification that an individual is a member of a target group must be made or requested before the individual begins work. Because of the potential for substantial revenue losses if retroactive certifications continued, this change was made generally effective on July 23, 1981, the date on which the Senate passed this provision.

Third, the Congress believed that cooperative education students should be eligible only if they are members of economically disadvantaged families. Also, in order to improve the employment situation of individuals who lose their jobs as a result of the termination of the Comprehensive Employment and Training Act (CETA) public service employment program, the Congress added this new target group.

Fourth, the WIN credit is merged with the targeted jobs credit. The existence of similar credits for different groups of employees has proved to be confusing to employers. It is expected that including AFDC recipients and WIN registrants in the targeted jobs credit will increase the hiring opportunities available to these individuals and simplify the overall administration of the program.

Fifth, the Act provides that the State employment security agencies and the United States Employment Service are the agencies which have the responsibility for administering and publicizing the credit. The diffusion of responsibility among several agencies in the past few years has limited employer participation. In order to provide sufficent funds to these agencies for the expenses incurred in administration, $30 million of appropriations is authorized for fiscal year 1982.

In addition, the Act makes various technical amendments in order to simplify the structure and administration of the credit.

Explanation of Provision

The Act extends the time period for which the targeted jobs tax credit will be available, revises definitions of some of the target groups, changes the certification rules, and makes other changes of an administrative and technical nature.

Extension of credit

Under the Act, the targeted jobs tax credit is available for wages paid to eligible individuals who begin work for the employer before January 1, 1983. Thus, if an eligible individual begins work on December 31, 1982, the employer may claim the credit for qualified first-year and qualified second-year wages paid to that employee attributable to service rendered in 1983 and 1984, respectively.

Target groups

Several changes are made by the Act to the definitions of target groups for purposes of the targeted jobs credit.

First, the credit for youths participating in qualified cooperative education programs is limited to youths who are certified by the designated local agency as being members of an economically disadvantaged family, for wages paid or incurred after December 31, 1981. This new requirement is intended to be met only at the initial determination of whether the individual is a member of an economically disadvantaged family. Thus, wages paid to an otherwise eligible youth continue to be qualified wages, even if the youth's family income increases after the initial determination so that the family would no longer be economically disadvantaged if a subsequent determination were performed. In contrast, as under prior law, wages paid to a youth are qualified wages only if the youth is age 16 to 19, not a high school graduate, and an active participant in the cooperative education program while the services are performed for the employer.

Second, individuals who are involuntarily terminated after December 31, 1980 from public service employment financed under the Comprehensive Employment and Training Act (CETA) are added as a target group.

Third, WIN registrants and AFDC recipients are added to the list of target groups for amounts paid or incurred in taxable years beginning after December 31, 1981. (The WIN credit is terminated and is not available for these amounts.) For these individuals, the determination of the amounts of credit and qualified first-year and second-year wages shall be made as if the employees had been members of a target group for taxable years beginning before January 1, 1982.

Fourth, in the case of Vietnam-era veterans, the age limitation is eliminated. Thus, employers will be able to claim the credit for hiring otherwise qualifying Vietnam-era veterans who are age 35 or over.

Certification

General rule

The Act revises the requirements for certification of individuals or members of target groups.

In general, under the Act an individual is not treated as a member of a target group unless the certification is received or requested in writing by the employer, from the designated local agency, before the day on which the individual begins work for the employer. (The Congress intended that this requirement would be satisfied if the certification is received or requested on the day on which the individual begins work for the employer.) In the case of a certification of a youth participating in a cooperative education program, this requirement will be satisfied if necessary certification has been requested or received from the participating school on or before the day on whch the individual begins work for the employer.

Effective dates for new certification rule

The effective date of this rule depends on the date the target group individual begins work for the employer.

For an individual, other than a cooperative education student, who began work for the employer earlier than the date (June 29, 1981) 45 days before the date of enactment, the certification has to have been requested or received before July 23, 1981 in order to be valid.

For an individual, other than a cooperative education student, who began work during the 90-day period beginning with the date (June 29, 1981) 45 days before the date of enactment, or for a cooperative education student who began work before the end of this 90-day period, the certification must have been requested or received before the last day of the 90-day period (September 26, 1981) in order to be valid.

The transition rules do not apply to any individual in a target group who begins work after September 26, 1981. For these individuals, the necessary certification must be requested or received on or before the day on which the individual begins work for the employer in order to be valid.

Other changes

The Act makes two other changes in the certification requirements. First, if a certification is incorrect because it was based on false information provided by a member of a target group, the certification is to be revoked, so that wages paid after the revocation notice is received by the employer are not treated as qualified wages. This change is effective for all individuals, regardless of the date on which they began work for the employer. Second, a determination that an individual is a member of an economically disadvantaged family is based on whether family income, during the 6 months immediately preceding the month in which the determination occurs, would be, on an annual basis, 70 percent or less of the Bureau of Labor Statistics lower living standard. This determination is valid for 45 days from the date on which the determination is made.

Administration of certification and publicity

The Act provides that the "designated local agencies" are the State employment security agencies. Thus, these agencies will issue those certifications which the statute requires to be issued by the designated local agency if the credit is to be claimed by employers. Moreover, the Act provides that the United States Employment Service (rather than the Department of Labor) has the responsibility for keeping employers apprised of the availability of the targeted jobs tax credit. These changes are effective 60 days after the date of enactment.

In order to insure that sufficient funds are available for adequately administering the certification system and providing publicity, the Act authorizes $30 million of fiscal 1982 appropriations for these purposes. Of the amounts appropriated, $5 million is to be used to test whether the certification system used by the State employment security agencies adequately screens out individuals who are not eligible for certification. The study is to rely on established quality control techniques, such as in-depth verification of eligibility for a sample of certified individuals. The study is to be coordinated by the Secretary of Labor, with the participation of the State agencies and the United States Employment Service.

The remaining funds are to be distributed under performance standards prescribed by the Secretary of Labor. The performance standards should provide incentives for the State agencies to use the credit as effectively as possible as a placement tool to obtain jobs for target group members who otherwise would not be employed and for the United States Employment Service to provide effective and complementary publicity.

Technical changes in credit eligibility

Two changes made by the Act preclude employers from claiming credit for wages paid to certain individuals. First, no credit is available for the hiring of certain related individuals (primarily dependents of the taxpayer). This is the same rule that applied with respect to the WIN credit. Second, the credit is not available for wages paid to an individual who had been employed by the employer at any time during which the individual was not a certified member of a targeted group. This denial of the credit had been the original intent of the prior law rules for certification and the determination of qualified wages.

Wage limitation

The Act eliminates the FUTA wage limitation on first-year wages eligible for the credit. Thus, employers receive credit for first-year wages paid to targeted employees even though those wages may exceed 30 percent of FUTA wages paid to all employees.

Effective Date

The amendments relating to definitions of target groups, certifications, and technical rules for eligibility generally apply to wages paid or incurred with respect to individuals first beginning work for an employer after the date of enactment (August 13, 1981) in taxable years ending after that date. Special effective date rules

are provided for changes relating to AFDC recipients and WIN registrants, cooperative education students, agencies which perform certification and publicity, and certifications, as described above.

The repeal of the FUTA wage limitation on qualified first-year wages applies to taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $63 million in 1982 and $13 million in 1983, and to increase fiscal year budget receipts by $57 million in 1984, $117 million in 1985, and $161 million in 1986.

2. Amortization of real property construction period interest and taxes for low-income housing (sec. 262 of the Act and sec. 189 of the Code)*

Prior Law

Individuals, subchapter S corporations, and personal holding companies must capitalize real property construction period interest and taxes in the year paid or accrued and amortize such amounts over a ten-year period, if the property is held (or will be held) for business or investment purposes (sec. 189).

However, under prior law section 189 would not apply to low-income housing until taxable years beginning after 1981, and the ten-year amortization period would not be fully phased in until 1988. For this purpose, low-income housing means government assisted or subsidized housing entitled to the special rules relating to recapture of depreciation (under sec. 1250(a)(1)(B)).

Reasons for Change

To attract capital for the construction of low-income housing, the Congress decided to exempt low-income housing from the rule requiring capitalization and amortization of construction period interest and taxes.

Explanation of Provision

Under the Act, construction period interest and taxes paid or accrued with respect to low-income housing are exempted permanently from application of section 189, and thus need not be capitalized and amortized.

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $14 million in 1982, $33 million in 1983, $27 million in 1984, $23 million in 1985, and $21 million in 1986.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8263-65 (daily ed. July 23, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 807; H. Rep. No. 97-201 (July 24, 1981), p. 286; H.R. 4242, as passed by the House (July 29, 1981), sec. 807; and H. Rep. No. 97-215 (August 1, 1981), p. 273 (Joint Explanatory Statement of the Committee of Conference).

3. Increase in deduction for charitable contributions by corporations (sec. 263 of the Act and sec. 170(b)(2) of the Code)*

Prior Law

A corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations (sec. 170). Under prior law, this charitable deduction was limited to five percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions were made. If the amount contributed exceeded the five-percent limitation, the excess could be carried forward and deducted for five succeeding years, subject to the five-percent limitation in those years.

Reasons for Change

The Congress believed that increasing the limit on the allowable corporate charitable contribution deduction will promote charitable giving by corporations.

Explanation of Provision

The Act increases the amount of deduction allowable to a corporation for charitable contributions made during the taxable year (including carryovers of excess charitable contributions made in prior years) from five percent to ten percent of its taxable income (computed with certain adjustments).

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $44 million in 1982, $93 million in 1983, $102 million in 1984, $112 million in 1985, and $123 million in 1986.

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S. 8351-53 (daily ed. July 24, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 271 (Joint Explanatory Statement of the Committee of Conference).

4. Amortization of low-income housing rehabilitation expenditures (sec. 264 of the Act and sec. 167(k) of the Code)*

Prior Law

A taxpayer may elect to amortize qualified low-income rental housing rehabilitation expenditures over a 60-month period (sec. 167(k)). Under prior law, the amount of eligible expenditures was limited to $20,000 per dwelling unit.

Reasons for Change

The Congress increased the limit on the section 167(k) rehabilitation expenditures in order to encourage taxpayers to rehabilitate certain low-income housing that is to be made available to tenant-purchasers under a program limiting the landlord-seller's profit.

Explanation of Provision

The Act increases the amount of rehabilitation expenditures eligible for amortization under section 167(k) to $40,000 per unit if the rehabilitation is conducted pursuant to a program under which tenants who demonstrate home ownership responsibilities may purchase their units at a price that limits the profit to the seller. The program must be certified by the Secretary of Housing and Urban Development (or by a State or local government), and the new tenants must occupy the units as their principal residence. The program must provide that the sum of the taxable income from leasing the unit and the amount realized on sale must not exceed the excess of (1) the taxpayer's basis in the property (without adjustment for amortization and depreciation deductions) over (2) the net tax benefits from these deductions less the tax on any taxable income from leasing.

Effective Date

The provision applies to expenditures incurred after December 31, 1980.

Revenue Effect

The provision is expected to reduce fiscal year budget receipts by $1 million in 1981, $8 million in fiscal year 1982, $16 million in 1983, $25 million in 1984, $35 million in 1985, and $39 million in 1986.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8326-27 (daily ed. July 24, 1981), and H. Rep. No. 97-215 (August 1, 1981), pp. 273-274 (Joint Explanatory Statement of the Committee of Conference).

5. Deduction for gifts and awards by employers to employees (sec. 265 of the Act and sec. 274(b) of the Code)*

Prior Law

Under Code section 274(b), business deductions for gifts (i.e., amounts which are excludable from the recipient's gross income under sec. 102) are disallowed to the extent that the total cost of all gifts of cash, tangible personal property, etc., to the same individual from the taxpayer during the taxable year exceeds $25. The $25 limitation is increased in the case of business gifts of items of tangible personal property which are awarded to employees for certain purposes. Under prior law, this exception to the general $25 limitation applied to an item of tangible personal property only if the item's cost did not exceed $100, and only if the item was awarded to an employee by reason of length of service or for safety achievement.

Reasons for Change

The Congress believed that gifts to employees by reason of length of service, productivity, or safety achievement serve to strengthen the relationship between a business and its employees.

Explanation of Provision

The Act increases the ceiling on deductions for business gifts to employees of items of tangible personal property and expands the purposes for which such gifts may be given.[1] The Act allows deductible employee gifts to be made for productivity, as well as for length of service or safety achievement, and increases the maximum allowable deduction from $100 to $400 of cost per item of tangible personal property which is awarded to an employee for such purposes. A deduction is allowed up to $400 of cost of an item if the cost of that item exceeds $400.

In addition, the amount of the allowable deduction for employee awards is further increased by the Act in cases where the item of tangible personal property is awarded for such purposes as part of a permanent, written plan or program of the taxpayer that does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits. A deduction is allowed for such plan awards of tangible personal property only if the average cost of all awards under all such plans of the taxpayer during the taxable year does not exceed $400. In addition, no deduction may be claimed under such an award plan or program

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S 8640 (daily ed. July 28, 1981); and H. Rep. No. 97-215 (August 1, 1981), p. 282 (Joint Explanatory Statement of the Committee of Conference).

[1] The Act does not change prior law as to whether amounts received by an employee constitute taxable compensation or a gift.

for a particular item of tangible personal property awarded to an employee for such purposes to the extent that the cost of the item exceeds $1,600.

Effective Date

The provision is effective for taxable years ending on or after the date of enactment (August 13, 1981).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $4 million in 1982, $5 million in 1983, $6 million in 1984, $7 million in 1985, and $9 million in 1986.

6. Deduction for diminution in value of motor carrier operating authorities (sec. 266 of the Act and chapter 1 of the Code)*

Prior Law

Background

Enacted in 1935, Part II of the Interstate Commerce Act (the "1935 Act") provided the basic framework for regulation of the motor carrier industry until enactment of the Motor Carrier Act of 1980. Under the 1935 Act, carriers were obligated to provide nondiscriminatory service at regulated rates for the public convenience and necessity, and further industry regulation was effected by issuing or withholding certificates of operating authority.

During the period 1935 to 1980, the Interstate Commerce Commission ("ICC") granted a limited number of permits and certificates of operating authority to motor carriers and freight forwarders. The basis for the grant of an authority from the ICC was a showing that additional services of the type for which authority was sought was, or would be, required by the public convenience and necessity. Businesses with existing operating rights could intervene in a proceeding for a request of operating authority to show that the proposed service was not, or would not be, required by the public convenience and necessity.

The right of existing operators to intervene (based on ICC procedural rules) and the applicant's burden of showing that the proposed service was required by the public convenience and necessity (based on the 1935 Act) gave existing operators protection against competition. Persons wishing either to enter the motor carrier business or expand an existing business, therefore, often would purchase an existing business with its operating authority.

Substantial amounts were paid for these operating authorities, reflecting, in part, the protection against competition afforded authority owners under ICC administration of the 1935 Act. The value of the operating authorities provided owners with an asset that constituted a substantial part of a carrier's asset structure and a source of loan collateral.

In 1975, the ICC began to grant a higher percentage of requests for operating authorities under the standard of "required by the public convenience and necessity." On July 1, 1980, the Motor Carrier Act of 1980 was enacted (P.L. 96-296). Under the 1980 Act,

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 252; S. Rep. No. 97-144 (July 6, 1981), pp. 102-104; H.R. 4242, as reported by the House Ways and Means Committee, sec. 809; H. Rep. No. 97-201 (July 24, 1981), pp. 289-292; H.R. 4242, as passed by the House (July 29, 1981), sec. 801; and H. Rep. No. 97-215 (August 1, 1981), pp. 237-238 (Joint Explanatory Statement of the Committee of Conference).

applicants need not show that the proposed service is required by the public convenience and necessity. Existing operators protesting the grant of an authority bear the burden of showing the proposed service is inconsistent with the public convenience and necessity. Thus, the 1980 statute further lessened restrictions on entry into the interstate motor carrier business. However, an operating authority still must be obtained to conduct interstate motor carrier business. As a result of the increased ease of gaining entry into the interstate motor carrier business, the value of motor carrier operating authorities has been diminished substantially.

The ICC, following an opinion of the Financial Accounting Standards Board, has required that the value assigned to certificates of authority in the regulated books of motor carriers be written off in one year.

Deduction for realized loss of property

Code section 165 allows a deduction for certain losses, including any loss incurred in a trade or business which is sustained during the taxable year and not compensated for by insurance or otherwise. In general, the amount of the deduction equals the adjusted basis of the property involved (sec. 165(b)).

Treasury regulations provide that, to be allowable as a deduction, the loss must be realized, i.e., "evidenced by closed and completed transactions, fixed by identifiable events" (Treas. Reg. § 1.165-1(b)). As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition of the property[1] nor for loss of anticipated income or profits.[2] Thus, for a loss to be allowed under section 165, generally either the business must be discontinued or the property must be abandoned or permanently discarded from use in the business (Treas. Reg. § 1.165-2). Generally, if a capital asset declines in value and is sold or exchanged at a loss, the loss is a capital loss, the deduction of which is subject to the limitations of sections 1211 and 1212 (sec. 165(f)).

The courts, in several decisions,[3] have denied a loss deduction when the value of an operating permit or license decreased as a result of legislation expanding the number of licenses or permits that could be issued. These decisions held that the diminution in the value of a license or permit did not constitute an event giving rise to a loss deduction under section 165 if the license or permit continued to have value as a right to carry on a business.

In the *Consolidated Freight Lines* case, the Ninth Circuit denied deductions for lost "monopoly rights" when the State of Washington deregulated the intrastate motor carrier industry by eliminating restrictions on entry. The court reasoned that the taxpayer had not lost any rights conferred by the certificate of operating authori-

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[1] See, e.g., *Reporter Publishing Co.* v. *Comm'r*, 201 F. 2d 743 (10th Cir.), cert. denied, 345 U.S. 993 (1953) (no deduction allowed to newspaper for decline in value of its membership in Associated Press after exclusivity feature held to violate antitrust laws) and *Monroe W. Beatty*, 46 T.C. 835 (1966) (no deduction allowed for diminution in the value of liquor license resulting from amendment of State law limiting grant of such licenses).

[2] See, e.g., *Alsop* v. *Comm'r*, 290 F. 2d 726 (2d Cir., 1961) and *Marks* v. *Comm'r*, 390 F. 2d 598 (9th Cir.), cert. denied, 393 (1968) (no loss deduction for difference between actual earnings and what taxpayer's earnings would have been absent revocation of her teaching credentials).

[3] *Consolidated Freight Lines, Inc.* v. *Comm'r*, 37 B.T.A. 576 (1968), aff'd, 101 F. 2d 813 (9th Cir.), cert. denied, 308 U.S. 562 (1939), and *Monroe W. Beatty, supra* note 1.

ty because the taxpayer still was permitted to do business and the operating authority had not given any further rights. Any "monopoly rights," the court stated, resulted from legislation and State administration restricting the availability of operating authorities. Since the taxpayer could not own (or purchase) property rights in legislation or regulations, repeal or modification of legislation or regulations did not give rise to a deductible loss, even if such action had the result of making the taxpayer's business property less valuable.

Reasons for Change

The deregulation of the interstate motor carrier industry has significantly reduced the value of motor carrier operating rights acquired before deregulation. In many cases, these rights represented a substantial part of a taxpayer's equity in its business and often were pledged to raise capital. The legislative history of the Motor Carrier Act of 1980 recognized that deregulation might require future consideration of relief for the diminution of the value of these rights.[4]

The Congress concluded that the unique circumstances of the deregulation of the interstate motor carrier industry made necessary some form of relief that was not available under prior tax law.

Explanation of Provision

The Act provides that an ordinary deduction is allowed ratably over a 60-month period for taxpayers who held one or more motor carrier operating authorities on July 1, 1980. The amount of the deduction is the total adjusted bases of all motor carrier operating authorities either held by the taxpayer on July 1, 1980, or acquired after that date under a binding contract in effect on July 1, 1980. The 60-month period begins July 1, 1980 (or at the taxpayer's election, with the first month of the taxpayer's first taxable year beginning after July 1, 1980).

Under the Act, adjustments are to be made to the bases of operating authorities held on July 1, 1980 (or acquired thereafter under a binding contract in effect on July 1, 1980) to reflect amounts allowable as deductions.

Under regulations to be prescribed by the Treasury Department, an election may be made by the taxpayer holding an operating authority on July 1, 1980, to allocate to the operating authority a portion of the cost basis to the acquiring corporation of stock in an acquired corporation. The election is available only if the operating authority was held directly by the acquired corporation at the time its stock was acquired or was held indirectly through one or more other corporations. In either case, a portion of the stock basis may be allocated to the operating authority only if the acquiring corporation would have been able, if it had received the operating authority in one or more corporate liquidations immediately following the stock acquisition, to allocate such portion to the operating authority under section 334(b)(2). The election applies only if the stock was acquired on or before July 1, 1980 (or pursuant to a binding contract in effect on such date) and only if, on the date the

[4] See H. Rep. No. 96-1069, 96th Cong., 2d Sess. 4, 11 (1980).

stock was acquired, the acquired corporation held, directly or indirectly, the operating authority.

It is intended that this election will be available pursuant to regulations only if the holder of the qualified authority is the corporation that acquired the stock with respect to which the election applies or is a member of the affiliated group, as defined in section 1504(a), which includes such acquiring corporation.

Further, it is intended that under regulations, a holder will not have a choice of more than one election with respect to one operating authority because more than one qualified acquisition has been made by a member or members of an affiliated group.

In all cases, adjustments shall also be made to the basis of the acquiring corporation in the stock of the acquired corporation to take into account any allocation of the basis in the stock to an operating authority. In addition, the regulations shall, in all cases, provide for an appropriate adjustment to the basis of other assets.

Effective Date

The provision is effective for taxable years ending after June 30, 1980.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $21 million in 1981, $121 million in 1982, $71 million in 1983, $71 million in 1984, $54 million in 1985, and $18 million in 1986. This revenue effect includes $36 million in reduction in tax liabilities for calendar year 1980.

7. Rules for bad debt deductions of commercial banks (sec. 267 of the Act and sec. 585 of the Code)*

Prior Law

Commercial banks compute their bad debt deductions under either the experience method or the percentage of outstanding loans method (sec. 585). Under the Tax Reform Act of 1969, the percentage of outstanding loans method is phased out over an 18-year period. Under the phase-out schedule established under the 1969 Act, bad debt deductions generally are permitted to the extent necessary to increase the bad debt reserve to the following percentages of eligible outstanding loans: 1969 to 1975, 1.8 percent; 1976–1981, 1.2 percent; and 1982–1987, 0.6 percent. After 1987, the bad debt deduction of commercial banks is to be computed under the experience method.

Reasons for Change

In light of economic conditions which have resulted in higher bad debts, the Congress concluded that commercial banks should be permitted to compute their bad debt deductions for 1982 under the percentage of eligible loans method using a percentage of 1.0. This percentage will allow the Treasury Department sufficient time to determine whether the phase-out of the percentage of loans method is appropriate. In any event, the 1.0-percent rate will provide a more gradual transition to the experience method than provided under prior law.

Explanation of Provision

The Act provides that the applicable percentage under the percentage of eligible loans method of computing bad debt deductions of commercial banks is 1.0 percent for taxable years beginning in 1982 instead of the 0.6 percent provided by prior law. For years after 1982 and before 1988, the applicable percentage will be 0.6 percent.

Effective Date

The amendment made by the provision applies to taxable years beginning after 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $15 million in 1982 and $15 million in 1983.

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8585–86 (daily ed. July 28, 1981), and H. Rep. No. 97–215 (August 1, 1981), pp. 281–82 (Joint Explanatory Statement of the Committee of Conference).

TITLE III.—SAVINGS PROVISIONS

A. Interest Exclusion

1. Exclusion of interest on certain savings certificates (sec. 301 of the Act and secs. 116, 265, 584, 643, and 702 and new sec. 128 of the Code)*

Prior Law

Prior law did not include any specific provision for exclusion of interest earned on savings certificates. Under prior law (sec. 116), as applicable for calendar years 1981 and 1982[1] only, up to $200 ($400 on a joint return) of dividends and interest from a variety of domestic sources could be excluded from gross income.

Reasons for Change

During recent periods of high interest rates, building and loan associations, commercial banks, credit unions, and similar depository institutions have experienced substantial disintermediation. Depositors and investors in institutional demand deposits, certificates of deposit, and other time deposits have transferred their funds to higher yield financial instruments purchased from other sources (such as money market funds). Unlike depository institutions, the sources of most of these alternative instruments are not subject to statutory limits on the rates of interest they can pay, nor do they have to meet minimum reserve requirements.

In addition, building and loan associations and many banks and credit unions have made long-term, low-rate loans, especially home loans, in the past. Because of high interest rates, the current cost of obtaining funds to carry these old loans is higher than the income accruing on them. The resulting squeeze on the profitability and cash flow of many of these depository institutions may threaten their financial viability, particularly in light of the disintermediation caused by the competition from financial institutions whose interest rates are not regulated.

Another result of high interest rates has been a significant disruption in the mortgage credit market. Money for new long-term mortgages, when it has been available, has demanded very high rates. The home building industry has suffered as a result and many young couples no longer believe they can afford to own a home.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 301; S. Rep. No. 97-144 (July 6, 1981), pp. 107-110; Senate floor amendments, 127 Cong. Rec. S7787-99 and S7804-05 (daily ed. July 16, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 321; H. Rep. No. 97-201 (July 24, 1981), pp. 145-149; H.R. 4242, as passed by the House (July 29, 1981), sec. 301; and H. Rep. No. 97-215 (August 1, 1981), pp. 241-244 (Joint Explanatory Statement of the Committee of Conference).

[1] The Act repeals the $200/$400 exclusion for 1982 and allows section 116 to revert to the $100/$200 dividend exclusion allowed by the law previously in effect (except for an amendment with respect to joint returns).

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The Congress concluded that the temporary availability of a tax-exempt savings instrument which could be issued only by certain depository institutions will help to stem, and perhaps reverse, the flow of deposits out of these depository institutions while the banking committees and regulatory authorities seek long-term solutions to the problems faced by these thrift institutions. It also was anticipated that new savings could be generated by such instruments. In addition, the Congress believed that the temporary availability of lower cost funds from tax-exempt certificates for up to 27 months [2] will give troubled depository institutions an opportunity to retire much of the low-yield loan portions of their portfolios and replace them with more profitable assets.

Finally, the Congress believed that there should be a requirement that a portion of new deposits be invested in housing-related or agricultural loans.

Explanation of Provision

The Act provides for a lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on qualified tax-exempt savings certificates.

Qualified certificates

Overview

In general, qualified tax-exempt savings certificates are one-year certificates, issued after September 30, 1981, and before January 1, 1983, by a qualified depository institution. The certificate must have a yield exactly equal to 70 percent of the yield on 52-week Treasury bills.

A qualified depository institution is a bank defined in section 581, a mutual savings bank, cooperative bank, domestic building and loan association, credit union, or any other savings or thrift institution chartered and supervised under Federal or State law, if the deposits or accounts of the institution are insured under Federal or State law or protected or guaranteed by State law. An uninsured industrial loan association or bank may issue tax-exempt savings certificates if it is chartered and supervised under Federal or State law in a manner similar to the manner in which savings and loan institutions are chartered and supervised under the applicable Federal or State laws. Thus, for example, if a State requires savings and loan institutions to maintain reserves, to submit to periodic public audits and to make full disclosures of financial data, the uninsured industrial loan must be subject to similar requirements.

Certificate requirements

For interest to qualify for the exclusion, a certificate issued by a qualified institution must meet several requirements.

First, such certificates may be issued only during the period beginning on October 1, 1981, and ending on December 31, 1982. Interest paid after December 31, 1982, with respect to certificates properly issued on or before that date is entitled to the exclusion

[2] The first certificate may be issued on October 1, 1981, and the last issued will not mature until December 31, 1983.

except to the extent that it exceeds the lifetime limitations on the amount of the exclusion.

Second, the certificates must have a maturity period of one year. Thus, all of the interest excludable by virtue of the new provision will be earned before January 1, 1984.

Third, the certificate must have a yield exactly equal to 70 percent of the yield on 52-week Treasury bills. Whether a certificate meets this 70-percent requirement is determined by comparing the yield to maturity on the certificates (including the effect of any compounding of interest) to the yield to maturity on 52-week Treasury bills sold at the last Treasury auction to have occurred in a calendar week preceding the week the certificate is issued. Thus, assuming an issuing institution observes normal business hours, an auction of 52-week Treasury bills will determine the interest limitation on tax-exempt savings certificates issued from the Monday following such auction through the Saturday following the next auction of 52-week Treasury bills.

Finally, the issuing institution must provide that certificates are available for any deposit of $500. However, deposits of any smaller or greater amounts may also be accepted.

Required uses of certificate proceeds

75-percent rule

Generally, the provision requires that at least 75 percent of the proceeds of qualified certificates issued during any calendar quarter by an institution other than a credit union must be used to provide qualified residential or agricultural financing by the end of the subsequent calendar quarter.

In the case of an institution with net new savings for a calendar quarter less than the amount of certificates issued during that quarter, the 75-percent requirement applies to the amount of net new savings. For this purpose, qualified net savings is the amount by which deposits (including interest and dividends left on deposit) in passbook savings accounts, six-month money market certificates, 30-month small saver certificates, time deposits of less than $100,000, qualified certificates, and similar accounts, such as credit union share certificates, exceed the amount withdrawn or redeemed from such accounts measured at the beginning and end of each calendar quarter. A special rule limits the amount of certificates issued by a credit union that may be outstanding at the close of any calendar quarter to 100 percent of the credit union's savings deposits (e.g., share certificates but not share-draft accounts) as of September 30, 1981, plus ten percent of any new net savings as of the end of the quarter that exceed the credit union's savings deposits as of September 30, 1981.

The amount of qualified certificates, residential financing, and net new savings are to be determined on a net aggregate basis of all corporations (whether or not qualified depository institutions) which are affiliated corporations (within the meaning of sec. 1504), if a consolidated return is filed for any part of that calendar quarter.

Qualified residential financing

Qualified residential financing of an institution is any of the following provided by the institution:

(*a*) any loan secured by a lien on a single-family or multifamily residence;

(*b*) any secured or unsecured qualified home improvement loan (as defined in section 103A except that there is no $15,000 limit);

(*c*) any mortgage on a single-family or multifamily residence which is insured or guaranteed by the Federal, State, or local government or any instrumentality thereof;

(*d*) any loan to acquire a mobile home;

(*e*) any loan for the construction or rehabilitation of a single-family or multifamily residence;

(*f*) any mortgage secured by single-family or multifamily residences and purchased on the secondary market, but only to the extent purchases exceed sales of these mortgages;

(*g*) any security issued or guaranteed by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or security issued by any other person if the security is secured by mortgages, originated by a qualified institution, but only to the extent purchases exceed sales of these securities; or

(*h*) any agricultural loan.

The term single-family residence includes stock in a cooperative housing corporation as defined in section 216 and two-, three-, and four-family residences.

If an institution fails to meet the proceeds investment test at the end of any calendar quarter, it may not issue additional certificates until the requirement is satisfied.

Limitations

Lifetime limitations on exclusion amount

The amount that any individual may exclude from income under the new provision is limited to $1,000. This limitation applies to the aggregate of all interest paid on all certificates. Thus, a calendar year taxpayer who receives, for example, $800 of interest on a qualified certificate in 1982 and $500 in 1983 is allowed to exclude only $800 of interest in 1982 and $200 of interest in 1983.

In the case of individuals filing joint returns, the limit is increased to $2,000. This is true even if all of the $2,000 is earned by only one of the individuals filing the joint return. If two individuals file separate returns in one year and a joint return in the next year, the separate amounts of any exclusions claimed in the first year are combined and taken into account in applying the $2,000 limitation in the second year. Similarly, if two individuals file a joint return in one year, they are treated as each having claimed half the amount of any exclusion shown on that return in applying the limitation in any subsequent year for which they file separate returns or joint returns.

If a taxpayer earns interest in excess of the excludible amount, the first interest earned is the interest eligible for exclusion.

Eligible recipients

Interest on qualified certificates is excludable only if earned by individuals, or by estates that receive these certificates by reason of death of an individual who owned the certificate. In the case of a partnership, the individual partners may exclude their distributive shares of interest paid on qualified certificates held by the partnership subject to each partner's lifetime dollar limitation on the exclusion. (Under an amendment to section 702, each partnership is required to separately state the amount of such interest distributable to the partners.) In the case of a grantor trust, the grantor may exclude from income interest earned on qualified certificates which the grantor is treated as owning for income tax purposes under the grantor trust provisions. The exclusion is not available to trusts or corporations (including real estate investment trusts, subchapter S corporations, and regulated investment companies).

In applying the dollar limitation to estates, the estate is treated as having claimed any exclusion taken by the decedent or by a surviving spouse who files a joint return claiming an exclusion.

Redemption of certificate

If any portion of a certificate is disposed of (other than by reason of the holder's death) or redeemed before maturity, the exclusion from income is not available for any interest earned on the certificate for the year in which the certificate is redeemed or disposed of or in any subsequent year. The receipt of interest earned on the certificate before maturity is not a premature redemption. If interest paid on a certificate is excluded from income in one year and the certificate is prematurely redeemed or disposed of in a subsequent year, then the amount of excluded interest in the prior year must be included in income for the year of the redemption or disposition. Previously excluded amounts that are recaptured under this rule are not taken into account for purposes of the dollar limitation. Thus, if a holder redeems a certificate and reinvests a portion in a new certificate, interest on the new certificate can be excluded.

The Act provides that the use of a certificate or any portion of a certificate as collateral or security for a loan will be treated as a redemption of the entire certificate.

Debt to purchase certificates

The Act also denies deductions for interest paid on indebtedness incurred to purchase or carry investment in qualified tax-exempt savings certificates. These rules are the same as those that apply under present law with respect to debt incurred or continued to purchase or carry tax-exempt obligations (sec. 265(2)).

Coordination with interest and dividends exclusion

Since some interest earned in 1981 may otherwise be eligible for exclusion under both the new provision and the section 116 interest and dividend exclusion, the Act provides a special transition rule. This rule provides that any amount earned on a depository institution tax-exempt savings certificate may be excluded only under new section 128 and may not be excluded under the general interest and dividend exclusion in section 116 of prior law, even if the

interest on the certificate is not tax-exempt because of a premature redemption or disposition.

Study

The Act requires the Treasury Department to conduct a study, to be submitted to the Congress before June 1, 1983, of the new interest exclusion for qualified savings certificates, to determine the exemption's effectiveness in generating additional savings.

Effective Date

The provision generally applies to taxable years ending after September 30, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $398 million in 1982, $1,791 million in 1983, and $1,142 million in 1984.

2. Partial exclusion of dividend and interest income (sec. 302 of the Act, sec. 404 of the Crude Oil Windfall Profit Tax Act of 1980, and secs. 46, 116, 128, 265, 854, and 857 of the Code)*

Prior Law

Dividend and interest income received by individuals generally is subject to Federal income taxation (sec. 61). An exception to this rule applies to most interest received on State and local government obligations (sec. 103). In addition, a partial exclusion of dividend and interest income was provided under section 116.

Prior to enactment of the Crude Oil Windfall Profit Tax Act of 1980, section 116 provided an exclusion from gross income for the first $100 of dividends received by an individual from domestic corporations. In the case of a husband and wife, each spouse was entitled to a separate exclusion of up to $100 for dividends received with respect to stock owned by that spouse. In the Crude Oil Windfall Profit Tax Act of 1980, the Congress expanded section 116 to provide that up to $200 ($400 on a joint return) of dividend and interest income from certain domestic sources could be excluded from gross income. Any combination of eligible dividends and interest could be included within the limits. To encourage further analysis of the appropriate tax treatment of dividend and interest income, the Congress allowed the increase in the exclusion and the expansion of coverage to include interest income only in 1981 and 1982. After 1982, section 116 was scheduled to revert to its previous scope (i.e., a $100 exclusion of dividends only).

Reasons for Change

The Congress believed that the partial exclusion of $200 ($400 for joint returns) of dividend and interest income had been inefficient in encouraging individual savings. In particular, the exclusion provided no added incentive for individuals to save an amount sufficient to earn interest in excess of the excluded amount.

The Act contains a variety of new or expanded incentives for individual savings and investment, including reductions in the top marginal tax rate on investment income, a temporary program of tax-exempt savings certificates, increases in the limitations on retirement savings, and a program for dividend reinvestment. In light of the new incentives, the Congress believed it is unnecessary to retain the partial interest exclusion in 1982. However, the Congress also believed that a permanent savings incentive based on net savings should replace the temporary tax-exempt savings certifi-

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 302; S. Rep. No. 97-144 (July 6, 1981), pp. 105-106; Senate floor amendment, 127 Cong. Rec. S7789-7799 (daily ed. July 16, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 322; H. Rep. No. 97-201 (July 24, 1981), pp. 150-151; H.R. 4242, as passed by the House (July 29, 1981), sec. 302; and H. Rep. No. 97-215 (August 1, 1981), pp. 240-241 (Joint Explanatory Statement of the Committee of Conference).

cate program. Accordingly, the Act provides a 15-percent net interest exclusion beginning in 1985.

Explanation of Provision

Dividend and interest exclusion

The Act repeals the present $200 ($400 on a joint return) interest and dividend exclusion for taxable years beginning after December 31, 1981. Thus, the $200/$400 exclusion is available only for taxable years beginning in 1981. For subsequent years, the $100 dividend exclusion previously in effect is available. However, an amendment allows an exclusion of up to $200 to be claimed on a joint return without regard to which spouse actually receives the dividends.

Net interest exclusion

The Act also provides for an exclusion of 15 percent of net interest received up to $3,000 of net interest ($6,000 on a joint return) starting in 1985. Net interest is generally defined as eligible interest received by the taxpayer in excess of the amount of interest payments by the taxpayer for which an income tax deduction is allowed. Thus, if an individual does not claim any itemized deductions, interest payments made by the individual are not taken into account to reduce eligible interest. Also, mortgage interest and trade or business interest are not taken into account to reduce eligible interest. For this purpose, mortgage interest is interest paid on debt incurred to acquire, construct, reconstruct, or rehabilitate property the taxpayer uses primarily as a dwelling.

Definition of eligible interest

Interest eligible for the exclusion includes: (1) interest on deposits received from a bank; (2) interest (whether or not designated as interest) paid in respect to deposits, investment certificates, or withdrawable or repurchasable shares by a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, credit union, or other savings or thrift institution chartered and supervised under Federal or State law if the deposits or accounts of the institution are insured under Federal or State law, or protected and guaranteed under State law; (3) interest on bonds, debentures, notes, certificates, or other evidences of indebtedness of a domestic corporation which are in registered form; (4) interest on other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public to the extent provided in regulations issued by the Treasury; (5) interest on obligations of the United States or a State or local government which is not already excluded from gross income; (6) interest attributable to a participation share in a trust established and maintained by a corporation established pursuant to Federal law (for example, interest attributable to a participation share in a trust established and maintained by the Government National Mortgage Association); and (7) interest paid by an insurance company under an agreement to pay interest on prepaid premiums, life insurance proceeds left on deposit, and, to the extent provided for in Treasury regulations, other amounts left on deposit.

Distributions from "conduit" entities

In the case of distributions received by individuals from conduit entities (such as trusts, regulated investment companies, and real estate investment trusts), the distributions generally qualify for the exclusion to the same extent that the gross income of the entity consists of eligible dividends or eligible interest.

Regulated investment companies.—In the case of a regulated investment company, conduit treatment is extended to qualifying dividends and to qualifying interest (as under prior law).

The amount of interest received by a regulated investment company that will be eligible for the exclusion when it is distributed to shareholders is the net amount of qualifying interest (i.e., qualifying interest less interest expense). If a regulated investment company has at least 75 percent of its gross income from qualified dividends, then the entire amount of the dividend (other than capital gain dividend) is treated as a dividend eligible for the section 116 exclusion. If 75 percent of gross income is from qualified interest, then the entire dividend (other than capital gain dividend) is treated as interest eligible for the percentage exclusion of section 128. If neither qualifying dividends nor qualifying interest equals or exceeds 75 percent of the gross income, then the percentage of each dividend it pays that qualifies for the section 116 and 128 exclusions is the proportion of that dividend that the qualifying dividends or qualifying interest of the regulated investment company for the taxable year bears to the gross income of the regulated investment company for the taxable year.

For this purpose, gross income and aggregate interest are to be reduced by any interest expense to the extent of any qualified interest. For example, if a regulated investment company has 30 percent of its gross income from qualified dividends and 50 percent of its gross income from qualified interest, then 30 percent of its dividends (other than its capital gain dividend) is a qualified dividend eligible for the section 116 exclusion in the hands of an individual shareholder and 50 percent of its dividend (other than its capital gain dividend) is treated as interest eligible for the section 128 percentage exclusion.

Real estate investment trusts.—In the case of a real estate investment trust, conduit treatment applies only to qualifying interest. If a real estate investment trust has at least 75 percent of its gross income from qualifying interest, then the entire amount of a non-capital gain dividend from the real estate investment trust is interest in the hands of an individual shareholder. If qualifying interest does not equal or exceed 75 percent of the gross income, then the percentage of its non-capital gain dividend that qualifies for the exclusion is the proportion of such dividend that the qualifying interest of the real estate investment trust for the taxable year bears to the gross income of the real estate investment trust for the taxable year.

As in the case of regulated investment companies, only the net amount of the qualifying interest (i.e., qualifying interest less interest expense) is eligible for the exclusion. However, in the case of a real estate investment trust, the amount of qualified interest is not reduced by any interest paid by the real estate investment trust on mortgages on real property that is owned by the real estate invest-

ment trust. In addition, gross income is to be reduced by the net capital gain and by any taxes imposed on income from foreclosure property (sec. 857(b)(4)), on the failure to meet certain requirements (sec. 857(b)(5)), or on income from prohibited transactions (sec. 857(b)(6)). The amount that qualifies for the exclusion shall not exceed the amount designated by the real estate investment trust in a notice to its shareholders sent within 45 days after the close of its taxable year.

Special rules

In addition, special rules are provided with regard to interest expenses incurred in order to purchase or to carry obligations or shares or to make deposits or other investments with respect to which the interest would be excludible from gross income under this provision.

Effective Date

The repeal of the $200/$400 interest exclusion is effective for interest received in taxable years beginning after December 31, 1981.

The 15-percent net interest exclusion applies to taxable years beginning after December 31, 1984.

Revenue Effect

The repeal of the $200/$400 exclusion is estimated to increase fiscal year budget receipts by $566 million in 1982 and $1,916 million in 1983.

The net interest exclusion provision is estimated to reduce fiscal year budget receipts by $1,124 million in 1985 and $3,126 in 1986.

B. Retirement Savings Provisions

1. Individual retirement savings (sec. 311 of the Act and secs. 62, 72, 219, 220, 401, 402, 403, 408, 409, 415, 2039, 2503, 2517, 3401, 4973, 6047 and 6652 of the Code)*

Prior Law

Individual retirement accounts

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity, or used to purchase retirement bonds (referred to collectively as "IRA's").

The prior-law limit on the deduction for a taxable year was generally the lesser of 15 percent of compensation [1] for the year or $1,500. Under a spousal IRA, the $1,500 contribution limit was increased to $1,750 for a year, if (1) the contribution was equally divided between an individual and the spouse of the individual and (2) the spouse had no compensation for the year. However, no IRA deduction was allowed for a taxable year to an individual who was an active participant during any part of the taxable year in a qualified pension, profit-sharing, stock bonus, or bond purchase plan, a tax-sheltered annuity program maintained by certain tax-exempt organizations or by public educational organizations, or a government plan (whether or not qualified). Except for tax-free rollovers and certain amounts paid for life insurance under an endowment contract, nondeductible contributions are not permitted to be made to an IRA.

Income and gain on amounts held under an IRA are not taxed until distributed. Except in the case of certain correcting distributions, all distributions from IRA's are includible in gross income. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional ten-percent income tax. If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70½, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 311; S. Rep. No. 97-144 (July 6, 1981), pp. 111-115; Senate floor amendment, 127 Cong. Rec. S7853-54 (daily ed. July 17, 1981); H.R. 4242, as reported by the House Ways and Means Committee, secs. 301-302; H. Rep. No. 97-201 (July 24, 1981), pp. 132-137; H.R. 4242, as passed by the House (July 29, 1981), sec. 311; and H. Rep. No. 97-215 (August 1, 1981), pp. 239-240 (Joint Explanatory Statement of the Committee of Conference).

[1] Under Regs. § 1.219-1(c)(1), compensation means wages, salaries, professional fees, or other amounts derived from or received for personal services actually rendered. The regulation does not classify benefits received under a pension plan or other plan of deferred compensation as compensation for this purpose.

Simplified employee pensions

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), prior law increased the annual IRA deduction limit to the lesser of $7,500 or 15 percent of compensation. The increased deduction limit applies only to employer contributions. Under prior law, an employee with a SEP was entitled to make additional deductible contributions to an IRA only to the extent that the annual deduction limit (i.e., the lesser of 15 percent of compensation or $1,500) exceeded the amount contributed by the employer for the year to the SEP.

An individual retirement account or individual retirement annuity qualifies as a SEP for a calendar year if certain requirements relating to employee withdrawals and the employer contribution allocation formula are met. The allocation rules are designed to insure that employer contributions are made on a basis that does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Employee contributions

Many qualified plans and government plans provide for contributions by both the employer and the employee. Employer contributions to a qualified plan generally are excluded from an employee's income, but under prior law no deduction or exclusion was generally allowed for employee contributions.

In many cases, the employee contributions are mandatory (i.e., required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions.

Employee contributions to a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, within certain limits, there is presumed to be no discrimination with respect to voluntary employee contributions so long as the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees.

A trust forming a part of a qualified plan is generally tax-exempt. Under prior law, employer contributions under a qualified plan and investment earnings on employer and employee contributions under the plan were generally not taxed to the employee (or a beneficiary) until paid, distributed, or made available.

Benefits under a qualified plan could qualify for exclusion under the estate tax and gift tax rules of prior law to the extent not attributable to employee contributions.

Tax-sheltered annuities

In the case of tax-sheltered annuities (including custodial accounts investing in shares of a regulated investment company) purchased for employees by certain tax-exempt organizations or by public educational organizations, the employee is entitled to an exclusion from gross income for amounts paid by the employer on a salary reduction basis (within limits). Amounts invested in a tax-

sheltered annuity purchased by a tax-exempt organization can qualify for exclusions under the estate tax and gift tax rules.

Reasons for Change

The Congress was concerned that a large number of the country's workers, including many who are covered by employer-sponsored retirement plans, face the prospect of retiring without the resources needed to provide adequate retirement income levels. The Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

It was understood that personal savings, when compared to personal disposable income (i.e., personal income after personal tax payments), have recently declined. During the years 1973 through 1975, the personal saving rate was as high as 8.6 percent. It declined to 5.2 percent in 1978 and 1979 and rose only slightly in 1980 to 5.6 percent. These savings estimates include employer payments to private pension funds.

The Act is designed to promote greater retirement income security by increasing the amount which individuals can set aside in an IRA and by permitting active plan participants to contribute to an IRA on the same basis as non-participants. The Act also extends additional tax-favored treatment to voluntary employee contributions to employer-sponsored plans, so that plan participants can take advantage of systematic payroll deductions to accumulate tax-favored retirement savings.

Budgetary limits precluded the Congress from giving extended consideration to the merits of providing additional tax-favored treatment to mandatory employee contributions to employer-sponsored plans by allowing a deduction for such contributions. The Congress intends that the question of deductibility of mandatory contributions to employer-sponsored plans be further reviewed on the merits when budgetary constraints permit.

Explanation of Provision

Deduction limits

General rules

The Act generally increases the annual deduction limit for IRA contributions to the lesser of $2,000 or 100 percent of compensation. Under the Act, any individual (including an active plan participant) is eligible for the deduction, so long as the individual has compensation includible in gross income and has not attained age 70½ before the close of the taxable year.

The Act also allows an employee who is a participant in a qualified plan, tax-sheltered annuity program, or government plan, a deduction for qualified voluntary employee contributions made by or on behalf of the employee to the plan. The deduction allowed for contributions to an IRA is reduced by the amount of deductible voluntary employee contributions to a plan. Thus, the deduction allowed for the total of (1) an employee's contributions to an IRA and (2) the employee's qualified voluntary employee contributions

to a plan (or plans) for a year, generally is limited to the lesser of $2,000 or 100 percent of compensation for the year.

An employee for whom an employer contributes under a simplified employee pension (SEP) is allowed a deduction for the employee's own contributions to the SEP or to a separate IRA without regard to the deduction allowed to the employee for employer contributions to the SEP. Under the SEP rules, the annual deduction limit for employer contributions is applied with respect to contributions by, and compensation from, each separate, unrelated employer.

Spousal IRAs

Under the Act, an individual also is allowed a deduction for contributions to an IRA (but not to a qualified plan, etc.) for the benefit of the individual's spouse who has not attained age 70½ if (1) the spouse has no compensation for the year and (2) the couple files a joint income tax return for the year.

If deductible contributions are made (1) to an individual's IRA or to the plan of the individual's employer and (2) to an IRA for the noncompensated spouse of the individual, then the annual deduction limit on the couple's joint return is increased to $2,250 (or 100 percent of compensation includible in gross income, if less). The prior-law requirement that contributions under the spousal IRA be equally divided between the spouses is deleted. The annual contributions may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000 and the total contributions for both spouses do not exceed $2,250 (or 100 percent of compensation, if less).

If an individual contributes to an IRA or to a plan on the individual's behalf and also contributes to an IRA for the benefit of a spouse, the deduction allowed the individual for the contributions is assigned first to the contributions made on the individual's behalf and then to the contributions for the benefit of the spouse. For example, if an individual whose compensation exceeds $2,250 contributes $1,800 to an IRA for the individual's own benefit and also contributes $1,500 to an IRA for the benefit of a spouse having no compensation, then the $1,800 for the individual is deductible, $450 of the amount contributed for the spouse is deductible ($2,250—$1,800=$450), and $1,050 of the amount contributed for the spouse is an excess contribution ($1,500—$450=$1,050).

Divorced individuals

The Act also allows certain divorced individuals a deduction for IRA contributions taking into account alimony received by the individual during the year. If certain requirements are met, then the IRA deduction limit is not less than the lesser of (1) $1,125 or (2) the sum of the individual's compensation and certain alimony includible in the individual's gross income for the year. This deduction limit applies, however, only if (1) an IRA was established for the benefit of the individual at least five years before the beginning of the calendar year in which the decree of divorce or separate maintenance was issued and (2) for at least three of the most recent five taxable years of the former spouse ending before the taxable year in which the decree was issued, the former spouse

paying the alimony was allowed a deduction under the spousal IRA rules for contributions for the benefit of the individual.

Qualified voluntary employee contributions

Plan requirements

A participant's contributions to a qualified plan, a tax-sheltered annuity program, or a government plan are qualified voluntary employee contributions only if (1) the contributions are not mandatory, (2) the plan allows the participant to make contributions which may be treated as deductible contributions, and (3) the participant does not designate that the contributions are to be treated as nondeductible. Only those qualified voluntary employee contributions not in excess of the lesser of $2,000 or the employee's compensation for the year from the employer may be treated as deductible contributions under the plan. If the result is not discriminatory, a plan administrator may provide for a lower annual limit for deductible employee contributions, may accept only contributions in excess of a stated minimum, or may preclude deductible employee contributions completely.

It is intended that a plan will be considered to allow a participant to make deductible contributions if the employer or plan administrator, by an affirmative action, manifests an intent that an employee's voluntary contributions be deductible (*e.g.,* by providing a means for accounting for such contributions and by giving appropriate notice to employees), provided that such manifest intent is not inconsistent with the plan provisions. Accordingly, the plan must provide for voluntary employee contributions, but need not expressly provide for deductible contributions. In addition, it is intended that if a plan, by its terms, limits an employee's voluntary contributions to a maximum amount that is less than the deduction limit under the Act, only those contributions within the plan limit may be treated as voluntary employee contributions under the plan.

Compensation limitation

Although the deduction for a participant's voluntary employee contributions is limited to 100 percent of the participant's compensation from the employer for the year, an employee is not thereby precluded from contributing as of any date in the year an amount that exceeds the compensation paid at the time of the contribution. Thus, a plan may permit an employee to make a deductible employee contribution of up to $2,000 on January 31, even if the contribution exceeds the compensation paid during January. In addition, an employee who separates from the service of the employer during the year is not precluded under the Act from making voluntary contributions to the plan after the separation. Of course, in either case, the contribution would be nondeductible to the extent it exceeds 100 percent of compensation from the employer which is includible in the employee's gross income for the year.

If an employee's voluntary contributions under a plan for the year exceed the Act's deduction limit, generally all amounts contributed until the deduction limit is reached are to be treated as deductible contributions, and all contributions made thereafter are to be treated as nondeductible. However, the plan administrator

(by permitting the employee a nondeductible designation or otherwise) may provide alternative procedures for accounting for an employee's contributions.

If an individual makes qualified voluntary employee contributions to a plan and also contributes to an IRA (whether for the individual's own benefit or for the benefit of a spouse), the deduction allowed the individual is assigned first to the contributions to the plan and then to the contributions to the IRA. For example, if an individual, whose compensation includible in gross income exceeds $2,000, contributes $2,000 to a plan as a qualified voluntary employee contribution and also contributes $2,000 to an IRA for the individual's benefit, the total amount contributed to the plan is a deductible employee contribution, and the total amount contributed to the IRA is an excess contribution. Of course, if the individual designates that the contribution to the plan is to be treated as a nondeductible contribution, the contribution to the IRA is deductible in full.

Employee designations

Treasury regulations are to provide rules under which an employee may be provided the opportunity to designate that all or a portion of otherwise deductible employee contributions under a plan are to be treated as nondeductible. Qualified voluntary employee contributions may be deducted by the employee even if no opportunity is provided to make the nondeductible designation or the procedures established for the designation are inconsistent with the regulations.

It is expected that the regulations will provide that an employee's nondeductible designation can be effective for no more than one taxable year and that the employee's voluntary contributions made in a subsequent taxable year are to be treated as deductible contributions unless the nondeductible designation is renewed. If the plan administrator permits, an employee may make or revise a nondeductible designation for a calendar year as late as April 15 of the following year. In addition, if the plan administrator of a plan accepting deductible employee contributions permits, voluntary employee contributions made no later than April 15 (or such earlier date as may be provided) may be treated as if made on the preceding December 31, if made on account of the previous calendar year.

Other rules

The Act continues the present law requirement for qualified plans that the opportunity to make voluntary contributions must be reasonably available to a nondiscriminatory group of employees. This availability standard applies to the aggregate of deductible and nondeductible voluntary contributions and to the deductible voluntary contributions alone. Accordingly, if a qualified plan provides a minimum contribution requirement for deductible employee contributions, such a requirement must not have the effect of discriminating in favor of highly compensated employees, etc.

If the availability standard is satisfied, the limit on the amount of voluntary contributions permitted under qualified plans of an employer is to be applied only to nondeductible voluntary contributions. In addition, qualified deductible employee contributions and

deductible IRA contributions (other than employer contributions to a SEP) are not taken into account for purposes of the overall limitations on contributions and benefits for qualified plans and tax-sheltered annuities (sec. 415). For example, an employer could maintain a separate qualified plan under which all contributions are made by payroll withholding. If the plan provides that each worker within a nondiscriminatory classification of employees is a plan participant and is permitted to make contributions to the plan, then (1) qualified voluntary employee contributions to the plan would be deductible (subject to the annual deduction limit), and (2) those voluntary employee contributions (if any) in excess of the deduction limit, and (if permitted) those contributions designated as nondeductible, would be taken into account under the qualified plan limits on voluntary employee contributions and the overall limits on contributions and benefits. Of course, if the plan required employee contributions as a condition of employment or plan participation, the required contributions would be nondeductible mandatory contributions.

The Act does not change the usual vesting rules for qualified plans, under which a participant's accrued benefit derived from employee contributions is nonforfeitable at all times. In addition, the Act does not modify the rules relating to when voluntary employee contributions may be distributed under a plan (see *Treatment of distributions, General rules,* below, for the tax treatment of distributions of accumulated deductible employee contributions). Also, the Act does not affect the computation of the exclusion allowance for an employee under a tax-sheltered annuity program.

A plan which accepts deductible employee contributions is not required to hold assets purchased with such contributions (or income and gain therefrom) apart from other plan assets. It is intended that an employee's deductible contributions are to be adjusted for income, gain, losses, and expenses under the plan at least annually.

Although the Act changes the tax treatment of voluntary employee contributions to a qualified plan and benefits derived from such contributions, the Act does not add new tax qualification requirements to the Code or modify the non-Code provisions of ERISA (the Employee Retirement Income Security Act of 1974).

Treatment of distributions

General rules

Accumulated deductible employee contributions (i.e., net qualified voluntary employee contributions adjusted for income, gain, loss, and expense) are subject to the same tax treatment accorded amounts held in an IRA, with certain exceptions. All distributions of accumulated deductible employee contributions are includible in gross income, except for tax-free rollovers. Distributions of accumulated deductible employee contributions may be made without penalty after age 59½ or in the event of disability or death. Other distributions of accumulated deductible employee contributions are subject to the same 10-percent additional income tax that applies to early withdrawals from an IRA.

Unless the plan provides otherwise, a distribution is not to be treated as being made from the accumulated deductible employee

contributions until all other amounts to the credit of the employee have been distributed. For this purpose, it is intended that if a distribution made with respect to an employee is actually charged against the accumulated deductible employee contributions, the distribution will be recognized as including such accumulated contributions without regard to plan provisions (or the lack of plan provisions) designating the source of the distribution.

Rollover transfers

A distribution of all or a part of an employee's accumulated deductible employee contributions from a qualified plan may be transferred under the rollover rules to an IRA or to another qualified plan if the plan administrator of the other plan (1) treats the amount transferred as accumulated deductible employee contributions, and (2) permits such transfers on a nondiscriminatory basis. The amount so transferred will not be taken into account under the limits on the amount of voluntary employee contributions under qualified plans. Such a rollover may be made without regard to whether the distribution is included in a lump sum distribution or a distribution on account of termination of the plan, and without regard to whether the distribution constitutes a total distribution of the accumulated deductible employee contributions under the distributing plan. In addition, if a distribution of accumulated deductible employee contributions from a qualified plan is rolled over tax-free to an IRA, a total distribution from the IRA which is attributable only to a rollover from a qualified plan may be rolled over to a plan under which the distribution will be treated as accumulated deductible employee contributions, etc. Similar rules are provided for tax-sheltered annuities.

Other rules

Under the IRA rules, tax-free rollovers are limited to one for each 12-month period, distributions must commence not later than the taxable year in which the individual attains age 70½, and distributions must be made within a prescribed time after the individual's death. These IRA rules do not apply to accumulated deductible employee contributions unless held in an IRA.

If accumulated deductible employee contributions are applied toward the purchase of life insurance, the amount so applied is treated as a distribution to which the usual tax rules for distributions apply. In addition, if an employee borrows from or against such accumulated contributions, the amount of the loan or security interest is treated as distributed. These income tax rules for accumulated deductible employee contributions are not required to be reflected in plan provisions relating to the distribution of plan benefits, the purchase of life insurance for employees, or the availability of loans to plan participants.

The distribution of, or the failure to distribute, accumulated deductible employee contributions under a qualified plan is not taken into account in determining whether a distribution of other amounts under the plan is a lump sum distribution. In addition, such accumulated contributions are not eligible for 10-year forward income averaging, long-term capital gain treatment, deferred recog-

nition of gain on employer securities, or the income tax death benefit exclusion for certain benefits under qualified plans.

For purposes of the estate tax and gift tax exclusions for qualified plans and certain tax-sheltered annuities, as well as for purposes of the income tax treatment of annuities, accumulated deductible employee contributions are treated as a benefit derived from employer contributions.

An employer is not required to withhold income tax on an employee's voluntary contributions to a plan if it is reasonable to believe that the employee will be entitled to a deduction for the contributions. No exemption is provided for these amounts for purposes of employment taxes under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Railroad Retirement Tax Act.

Treasury regulations are to provide rules under which the plan administrator of a plan accepting deductible employee contributions is to provide reports to the Treasury and to plan participants.

The Act makes a clarifying amendment with regard to the income tax treatment of the proceeds of a retirement bond purchased with a rollover contribution.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 1981. The amendments to the estate tax and gift tax rules apply to the estates of decedents dying and to transfers made after such date. The amendment relating to redeemed retirement bonds applies to taxable years beginning after December 31, 1974.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $229 million in 1982, $1,339 million in 1983, $1,849 million in 1984, $2,325 million in 1985, and $2,582 million in 1986.

2. Retirement plan deduction for self-employed individuals (secs. 312 and 314(a) of the Act and secs. 72, 219, 401, 404, 408, 1379, and 4972 of the Code)*

Prior Law

In general

A pension or profit-sharing plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and the employer, and a partnership is considered the employer of each partner.

A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an "H.R. 10 plan" or "Keogh plan" and is subject to special rules which are, in addition to the other qualification requirements under the Code. These special rules include limits on the contributions and benefits which can be provided for a self-employed individual. These limits are generally lower than the overall limits on contributions and benefits applicable with respect to all employees under qualified plans.

Limitations—self-employed individuals

Under a qualified defined contribution [1] H.R. 10 plan, annual deductible contributions on behalf of a self-employed individual generally were limited under prior law to the lesser of $7,500 or 15 percent of net earnings from self-employment. Nondeductible employee contributions by a self-employed individual are generally permitted, within limits, unless all employees covered by the plan are owner-employees. (An owner-employee is a sole proprietor or a partner whose partnership interest exceeds ten percent.) Annual contributions on behalf of a self-employed individual in excess of the combined limits on deductible and (if permitted) nondeductible contributions are subject to a six-percent nondeductible excise tax.

Under a qualified defined benefit [2] H.R. 10 plan, the annual benefit accruals for a self-employed individual are limited by a special schedule designed to permit the accrual of an annual pension benefit no greater than that which could be provided by the accumulated annual contributions on behalf of a self-employed individual permitted under a defined contribution H.R. 10 plan.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 312; S. Rep. No. 97-144 (July 6, 1981), pp. 116-118; Senate floor amendment, 127 Cong. Rec. S7855 (daily ed. July 17, 1981); H.R. 4242, as reported by the House Ways and Means Committee, secs. 303, 305(a); H. Rep. No. 97-201 (July 24, 1981), pp. 138-141; H.R. 4242, as passed by the House (July 29, 1981), secs. 312, 314(a); and H. Rep. No. 97-215 (August 1, 1981), p. 239 (Joint Explanatory Statement of the Committee of Conference).

[1] Defined contribution plans are plans under which each participant's benefit is based solely on the balance in the participant's account consisting of contributions, income, gain, expense, loss, and forfeitures allocated from the accounts of other participants (e.g., a profit-sharing plan or a money purchase pension plan).

[2] A defined benefit plan is a pension plan that specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of 2 percent of average pay for each year of employee service).

Limitations—subchapter S corporations

A qualified pension or profit-sharing plan maintained by an electing small business corporation (a subchapter S corporation) is subject to special limitations corresponding to those for H.R. 10 plans, as well as the overall limits on contributions and benefits applicable to all qualified plans. Under a qualified defined contribution plan of a subchapter S corporation, annual employer contributions on behalf of a shareholder-employee (an employee who owns more than five percent of employer stock) in excess of the annual deduction limit (under prior law, the lesser of $7,500 or 15 percent of compensation) are includible in the income of the shareholder-employee. Under a qualified defined benefit plan of a subchapter S corporation, benefits are limited under the same schedule that applies to a defined benefit H.R. 10 plan.

Limitations—simplified employee pensions

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), prior law increased the annual IRA deduction limit to the lesser of $7,500 or 15 percent of compensation. The increased deduction limit for a SEP applies only to employer contributions.

An individual retirement account or individual retirement annuity qualifies as a SEP for a calendar year if certain requirements relating to employee withdrawals and the employer contribution allocation formula are met. The rules are designed to insure that employer contributions are made on a basis that does not discriminate in favor of self-employed individuals or employees who are officers, shareholders, or highly compensated.

Limit on includible compensation

Under prior law, only the first $100,000 of compensation could be taken into account under an H.R. 10 plan, a plan of a subchapter S corporation, or a SEP.

Employee borrowing from qualified plans

A qualified plan generally is permitted to lend to a participant if certain requirements are met.[3] However, an H.R. 10 plan is not permitted to lend to an owner-employee and a subchapter S corporation's plan is not permitted to lend to a shareholder-employee.[4] Also, if an owner-employee participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the transaction is treated as a plan distribution, and the usual tax rules for distributions apply.

Plan termination distributions

An H.R. 10 plan must provide that no benefits will be paid to an owner-employee before he attains age 59½ or is disabled. If a distribution is made to an owner-employee in violation of the rule, no contributions may be made to an H.R. 10 plan on behalf of the owner-employee for the five taxable years following the taxable

[3] Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

[4] ERISA secs. 406(a)(1) and 408(d).

year of the distribution. Under prior law, this five-year ban applied even if the distribution was made on account of termination of the plan and whether or not the distribution was rolled over to an IRA.

Under the rules permitting tax-free rollovers of distributions from qualified plans, all or a part of the taxable portion of a total distribution made to an owner-employee on account of the termination of an H.R. 10 plan can be transferred, tax-free, to an IRA. The portion of the distribution rolled over to an IRA is not subject to the ten-percent additional income tax which generally applies to distributions received by an owner-employee before age 59½.

Reasons for Change

The deductible limit for contributions to H.R. 10 plans had not been revised since 1974. The Congress concluded that this limit should be increased to make these plans more attractive and that the $100,000 limit on includible compensation also should be adjusted.

Under prior law, partners who were not owner-employees could borrow against their interest in an H.R. 10 plan without penalty. The Congress was concerned that the widespread use of such loans diminishes retirement savings. Accordingly, the Congress concluded that the restrictions on loans and pledges previously applicable only to owner-employees should be applied to all partners.

The Congress also believed that timely corrections of excess contributions to H.R. 10 plans should be permitted and that contributions to an H.R. 10 plan should be allowed to continue without interruption where an owner-employee has received a distribution from a terminated H.R. 10 plan before attaining age 59½ or becoming disabled.

Explanation of Provisions

Increased contribution limit; excess contributions

In general, the Act increases the deduction limit for employer contributions to defined contribution H.R. 10 plans, defined contribution plans maintained by subchapter S corporations, and SEPs to $15,000. The 15-percent limit on contributions is not changed.

In addition, the Act provides that if an excess contribution is made to an H.R. 10 plan, the six-percent excise tax will not apply if the excess, together with any net income attributable to it, is withdrawn from the plan on or before the date for filing the return for the taxable year (including extensions). If a timely distribution of the excess contribution (and income) is made from an H.R. 10 plan, the excess contribution that is returned is not to be included in gross income because the individual has not been allowed a deduction for this amount. However, any net income attributable to the contribution is to be included in the individual's income for the year the contribution was made. This rule corresponds to a rule for excess contributions made to IRA's.

For defined benefit H.R. 10 or subchapter S corporation plans, the compensation that may be taken into account in determining permitted annual benefit accruals for owner-employee and shareholder-employees is increased to $100,000. To prevent retroactive increases in permitted benefit accruals, the Act continues the re-

quirement of prior law under which an increase in the compensation taken into account to determine benefit accruals under a plan is treated as starting a new period of plan participation (but only with respect to such increase).

Increase in includible compensation

Under the Act, the maximum amount of compensation which may be taken into account under an H.R. 10 or subchapter S corporation plan, or a SEP, is increased from $100,000 to $200,000. However, to insure that a plan which considers compensation in excess of $100,000 may not reduce contributions or benefits which would otherwise have been required for common-law employees, the Act prescribes minimum contribution or benefit levels.

In a defined contribution plan or a SEP which considers compensation exceeding $100,000, contributions on behalf of a common-law employee (in a SEP, any employee) must be made at a rate not less than 7.5 percent of the employee's compensation. However, this rule applies for a plan year only if compensation exceeding $100,000 is actually taken into account for that year.

In a defined benefit plan which takes compensation in excess of $100,000 into account, the annual benefit accrual for each common-law employee who has attained a particular age must be at least a percentage of compensation which is one-half of the maximum annual benefit accrual permitted under a defined benefit H.R. 10 plan for a self-employed individual who has attained that age.

As under prior law, the amount actually contributed or the benefit actually accruing under a particular plan for a participant may be less if the plan is integrated with social security. For example, a defined contribution plan which does not cover an owner-employee and which takes into account compensation in excess of $100,000 may provide for contributions of one-half of one percent of compensation up to the F.I.C.A. taxable wage base (or other stated integration level) and 7.5 percent of compensation in excess of the F.I.C.A. taxable wage base. A plan covering an owner-employee may also consider employer-provided social security benefits if integration is otherwise permitted for such plan.

In addition, contributions or benefits provided under another qualified plan of the employer may be taken into account for purposes of determining whether the minimum contribution or benefit accrual requirement is met. For example, if a partnership maintains an H.R. 10 plan for its partners and a comparable plan for its common-law employees, then contributions or benefits under the plan for common-law employees can be taken into account as if provided under the H.R. 10 plan in testing whether the minimum contribution or benefit requirements are met by the H.R. 10 plan.

Employee borrowing

The Act extends to all partners the rule under which a loan from an H.R. 10 plan, or the use of an interest in the plan as security for a loan, is treated as a distribution. Under the Act, all self-employed individuals will be treated as owner-employees for purposes of the loan rules, but not for purposes of the 10-percent additional income tax generally imposed on distributions made to owner-employees before attaining age 59½ or becoming disabled. Thus, the ten per-

cent penalty imposed upon distributions before age 59½ continues to apply only to sole proprietors and more-than-10-percent partners.

Plan termination distributions

The Act permits an owner-employee to receive distributions from a terminated H.R. 10 plan before attaining age 59½ or becoming disabled without subjecting that owner-employee to the 5-year ban on H.R. 10 contributions usually applicable in the case of a premature distribution. As under prior law, the portion of the distribution rolled over to an IRA is not subject to the ten-percent additional income tax which generally applies to distributions received by an owner-employee before age 59½.

Effective Date

These provisions generally are effective for employer taxable years beginning after December 31, 1981. However, the Act provides a transitional rule for a loan outstanding on December 31, 1981, to a partner who is not an owner-employee. Such a loan will be treated as a distribution from the plan only when renegotiated, extended, renewed, or revised after that date. The provision relating to excess contributions on behalf of an employee which are distributed from an H.R. 10 plan is effective for distributions received in taxable years of the employer beginning after December 31, 1981.

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by $56 million in 1982, $157 million in 1983, $173 million in 1984, $183 million in 1985, and $201 million in 1986.

3. Rollovers under bond purchase plans (sec. 313 of the Act and secs. 219, 405, 408, 2039, and 4973 of the Code)*

Prior Law

Under a qualified bond purchase plan, contributions by the employer and contributions (if any) by the employee are used to purchase special U.S. bonds issued under the Second Liberty Bond Act. Such bonds may also be purchased with amounts contributed to a trust forming a part of a qualified pension or profit-sharing plan. Bonds purchased for a plan participant are issued in the name of the participant (whose rights under the bond are nonforfeitable at all times) in denominations of $50, $100, $500, or $1,000.

A bond purchased for a plan participant may be redeemed only after the participant dies, attains age 59½, or is disabled. Redemption proceeds in excess of the amount contributed by the employee are includible in gross income as ordinary income. Under prior law, the proceeds could not be rolled over to an IRA.

Reason for Change

The Congress concluded that the rules preventing tax-free rollovers of the redemption proceeds from bonds distributed under a qualified plan were unnecessarily restrictive.

Explanation of Provision

In the case of a qualified bond purchased for an employee, all or any portion of the redemption proceeds in excess of the amount contributed by the employee may be rolled over, tax-free, to an IRA for the benefit of the recipient employee or beneficiary. As under prior law relating to rollovers, the contribution to the IRA must be made within 60 days after the redemption.

The Act does not change the rule under which a bond may not be redeemed before the individual dies, attains age 59½, or is disabled.

Effective Date

The provision applies to redemptions after the date of enactment (August 13, 1981), in taxable years ending after such date.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 304; H. Rep. No. 97-201 (July 24, 1981), p. 142; H.R. 4242, as passed by the House (July 29, 1981), sec. 313; and H. Rep No. 97-215 (August 1, 1981), p. 240 (Joint Explanatory Statement of the Committee of Conference); and S. Con. Res. 30, 127 Con. Rec. S. 9270 (Aug. 3, 1981) and H. 5993 (Aug. 4, 1981) (daily ed.).

4. Investments in collectibles by an individual retirement account or individually directed account under a qualified plan (sec. 314(b) of the Act and sec. 408 of the Code)*

Prior Law

Broad discretion generally is allowed with respect to investments by qualified plans and IRAs (individual retirement accounts) if self-dealing is not involved.[1] The prudent man and diversification standards of the Employee Retirement Income Security Act of 1974 (ERISA) do not apply to IRAs or to individually directed accounts of employees under qualified plans.

An individually directed account is an account in a qualified defined contribution plan which permits the plan participant to exercise control over the assets in the participant's account.

Only a bank, insurance company, or other qualifying financial institution can act as an IRA trustee or custodian. However, the owner of an IRA can self-direct the investment of assets in the account.

Reasons for Change

In recent years, there had been increasing interest in investing retirement savings in collectibles (coins, antiques, art, stamp collections, etc.) under IRAs and individually directed accounts in qualified plans. The Congress concluded that investments in collectibles do not contribute to productive capital formation. There was also concern that the present-law rules regarding self-dealing under qualified plans and IRAs are not adequate to prevent personal use of collectibles.

Explanation of Provision

An amount in an IRA or in an individually directed account in a qualified plan which is used to acquire a collectible is treated as if distributed in the taxable year of the acquisition. The usual income tax rules for distributions from an IRA or from a qualified plan apply.

An amount in such an account which is applied toward the purchase of a collectible is treated as if distributed from the account without regard to whether the purchase is made pursuant to the participant's exercise of such control. A participant's account in a qualified defined contribution plan is not individually directed for purposes of this provision merely because the participant, acting as a fiduciary with respect to the plan, directs or otherwise participates in the investment of plan assets.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 305(b); H. Rep. No. 97-201 (July 24, 1981), pp. 143-144; H.R. 4242, as passed by the House (July 29, 1981), sec. 314(b); and H. Rep. No. 97-215 (August 1, 1981), p. 240 (Joint Explanatory Statement of the Committee of Conference).

[1] Special rules apply to investments by qualified plans in employer real estate. Also, investments by pension plans in employer securities are subject to a special limitation.

The Act does not affect the tax treatment of an investment in shares of a regulated investment company (a mutual fund or a closed-end investment company). Accordingly, the purchase of shares of a regulated investment company by an IRA or an individually directed account would not be treated as a distribution under the new rules merely because, at the time of the purchase (or thereafter), the regulated investment company acquires collectibles.

A "collectible" is defined as any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other item of tangible personal property specified by Treasury regulations.

Although the Act changes the tax treatment of the acquisition of collectibles under individually directed accounts, the Act does not modify the tax-qualification standards of the Code for pension, profit-sharing, or stock bonus plans or the non-Code rules of ERISA. For example, the tax qualification of a plan is not adversely affected merely because an amount is treated as distributed to a participant under this provision at a time when the plan is not permitted to make a distribution to the participant.

It is intended that Treasury regulations will provide for appropriate adjustments that will avoid double taxation of benefits under a plan if the collectible is not actually distributed.

Effective Date

The provision is effective for property acquired after December 31, 1981, in taxable years ending after that date.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

5. Constructive receipt under qualified plans (sec. 314(c) of the Act and sec. 402(a) of the Code)*

Prior Law

Under prior law, amounts under a trust forming a part of a qualified plan were taxable to the employee or the employee's beneficiary when actually paid, distributed, or when made available to the distributee. Benefits were not considered made available (and therefore taxable) to the participant if any right of withdrawal was conditioned on the participant's showing economic hardship or was otherwise subject to a substantial restriction. For example, if an employee were entitled to withdraw all or a portion of the balance to the employee's credit under a plan, but employer contributions on the employee's behalf would be suspended for a minimum period following such a withdrawal, the right to make the withdrawal would not cause amounts to be made available to the employee because the suspension of employer contributions represented a substantial restriction.

Reasons for Change

The prior-law requirement that a qualified plan must provide rules constituting a substantial restriction on an employee's right to make withdrawals under the plan produced a significant administrative burden for plan participants, employers, plan administrators, and the Internal Revenue Service. The Congress concluded that the deletion of these rules, while promoting simplification, would not lead to abuse of the favorable tax treatment accorded qualified plans.

Explanation of Provision

Under the Act, amounts held in a trust forming part of a qualified plan are taxable to the employee or beneficiary only when paid or distributed under the plan. Of course, if benefits are paid with respect to an employee to a creditor of the employee, a child of the employee, etc., the benefits paid would be treated under the income tax rules as if paid to the employee.

This provision affects only the tax consequences to an employee or a beneficiary to whom amounts are payable under such a trust and does not affect present-law rules relating to a plan's tax qualification, including those rules requiring that a plan preclude distributions to a participant before the occurrence of a stated event. Also, the provision does not change the tax treatment of amounts actually paid or distributed by a trust.

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*For legislative background of the provision, see: H.R. 4242, as passed by the House (July 29, 1981), sec. 314(c); and H. Rep. No. 97-215 (August 1, 1981), pp. 239-240 (Joint Explanatory Statement of the Committee of Conference).

It is intended that the deletion from a plan of those provisions constituting a substantial restriction upon an employee's right to make withdrawals will not affect the availability of the estate tax and gift tax exclusions otherwise applicable to amounts payable under the plan with respect to the employee. It is also intended that corresponding changes will be made in administrative rules relating to annuity plans.

Effective Date

The provision is effective with respect to taxable years (of distributees) beginning after December 31, 1981.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

C. Public Utility Dividend Reinvestment Plans

(Sec. 321 of the Act and sec. 305 of the Code)*

Prior Law

A pro rata common stock distribution is not taxable to a shareholder when received; instead, it is taxable when the taxpayer sells or otherwise disposes of the shares received as a distribution (sec. 305(a)). Any gain on the sale generally is treated as a long-term capital gain if the underlying shares (with respect to which the distribution was made) were held for more than one year.

Under prior law, stock distributions which are not pro rata, including stock distributions received pursuant to a shareholder's option to receive either stock or cash, were generally taxable at fair market value when the shares are initially received. The rationale for this different treatment was that with pro rata stock distributions no shareholder has gained any increased interest in the corporation, since all shareholders receive a proportionately equal amount of additional stock. But with non-pro rata dividends, those receiving the stock distribution do gain an additional interest in the corporation relative to those not receiving stock. Thus, shareholders receiving the stock have gained some value, which is taxed as a dividend.

Reasons for Change

By enacting accelerated cost recovery provisions for depreciable property, the Congress acted to stimulate capital formation through internal generation of funds. In the case of public utilities, where property is to be recovered over a 10- to 15-year period under the Act, the Congress wished to encourage the additional generation of funds to provide capital for the purchase of new equipment through the reinvestment of dividends by shareholders. The Congress believed that an appropriate way to realize this objective was to allow tax-free treatment of certain stock distributions made to shareholders of public utility corporations.

Explanation of Provision

Overview

Under the Act, a domestic public utility corporation may establish a plan under which holders of common or preferred stock who choose to receive a distribution in the form of common stock rather than cash or other property generally may elect to exclude up to

* For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 341; H. Rep. No. 97-201 (July 24, 1981), pp. 152-153; H.R. 4242, as passed by the House (July 29, 1981), sec. 321; and H. Rep. No. 97-215 (August 1, 1981), pp. 245-246 (Joint Explanatory Statement of the Committee of Conference); and S. Con. Res. 30, 127 Con. Rec. S. 9270 (Aug. 3, 1981) and H. 5993 (Aug. 4, 1981) (daily ed.).

$750 per year ($1,500 in the case of a joint return) of the stock distribution from income.[1]

Qualifying Stock

To qualify, the stock must be newly issued common stock, designated by the board of directors of the corporation to qualify for this purpose. The number of shares to be distributed to any shareholder must be determined by reference to a value which is not less than 95 percent (and not more than 105 percent) of the stock's value during the period immediately before (or including) the distribution date.[2]

Generally, stock will not qualify if the corporation has repurchased any of its common stock within one year before or after the distribution date (or any member of the same affiliated group of corporations has purchased common stock of any other member of such group).

However, if the corporation establishes a business purpose for the purchase not inconsistent with the purpose of the dividend reinvestment provision to aid in the raising of new capital, the purchase will not disqualify any distribution otherwise eligible for exclusion. For example, the purchase of stock to buy out shareholders with very small amounts of stock in order to reduce administrative costs will not disqualify an otherwise qualified distribution. Redemptions under section 303 to pay estate taxes, and court-ordered or statutorily-required repurchases to buy out minority shareholders, will not be deemed inconsistent with the purpose of this section. Further, the repurchase of stock used to fund a qualified employee's trust will not disqualify a plan.

Disposition of qualified stock

Stock received as a qualified reinvested dividend will have a zero basis, so that when the stock is later sold the full amount of the sales proceeds will be taxable.

In general, gain from the sale of such stock will be taxed as capital gains. However, where a shareholder sells common stock (up to the amount of the reinvested dividend) sold after the record date for the distribution and not more than one year after distribution, all proceeds will be treated as ordinary income.[3] This rule is intended to prevent the immediate resale of stock without the recognition of ordinary income which would have resulted in the case of a taxable dividend.

Other rules

Under the Act, the earnings and profits of the distributing corporation will not be reduced by reason of the distribution of qualified

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[1] Under the provision, up to $750 (or $1,500) of stock received may qualify for treatment as a distribution of stock (under sec. 305(a)) rather than a distribution of property (under sec. 301), regardless of how the distribution would have been taxed had the distribution been a property distribution to which section 301(a) applied.

The term "qualified reinvested dividend" does not refer to a "dividend" as that term is used in secs. 301(c)(1) and 316.

[2] It is expected that the Treasury will promulgate regulations setting forth reasonable methods under which a corporation will be permitted to make these calculations.

[3] The basis in the distributed stock may be properly adjusted to take account of the basis in the stock sold, in accordance with regulations prescribed by the Treasury.

stock, whether or not the shareholder elects to treat the distribution as a stock distribution to which section 305(a) applies.[4]

Only individual shareholders are eligible to elect this special treatment. Corporations, trusts,[5] estates, non-resident aliens, and persons holding at least five percent of the voting power or value of stock in the corporation (using the attribution rules of sec. 318) are not eligible to exclude any distributions under this provision.

A corporation is qualified if, during the ten years prior to its taxable year in which the distribution is paid, at least 60 percent of the cost of all tangible property described in section 1245(a)(3) (other than subparagraphs (C) and (D)) acquired by the corporation or the members of an affiliated group (in which the public utility is a member) was 10-year property or 15-year public utility property (within the meaning of sec. 168(c)(2) determined as if the property had been placed in service after 1980).[6]

Effective Date

The provision applies to distributions made after December 31, 1981, and before January 1, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $130 million in 1982, $365 million in 1983, $416 million in 1984, $449 million in 1985, and $278 million in 1986.

[4] This rule is included for administrative reasons, since the corporation generally will not know whether a shareholder elects to have the distribution of stock treated under sec. 305(a). This rule applied under prior law for distributions under section 305(a) (sec. 312(d)(1)(B)). A corporation may have a nonqualified plan for those shareholders not making an election under which a distribution of stock may reduce earnings and profits.

[5] This rule does not apply to distributions with respect to stock treated as held by an eligible individual under secs. 671–678.

[6] It is not intended that the normalization requirement of sec. 168(e)(3) apply.

D. Employee Stock Ownership Provisions

(Secs. 331-339 of the Act and secs. 44G, 46, 48, 56, 383, 401, 404, 409A, 415, and 6699 of the Code)*

Prior Law

Overview

An employee stock ownership plan ("ESOP") is a tax-qualified plan[1] under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts).

Under the usual rules applicable to tax-qualified plans, an employee's benefits under an ESOP are generally not taxed until they are distributed. Also, the Code provides special ten-year forward income averaging or tax-free rollover treatment for lump sum distributions, deferral of tax on appreciation in employer securities, and estate tax and gift tax exclusions.

Tax credit ESOPs

An employee stock ownership plan under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP.

Under prior law, an employer was entitled to an additional percentage point of investment tax credit (i.e., 11 percent rather than ten percent) if it contributed an amount equal to the full additional credit to a tax credit ESOP. The contribution could be made in cash or employer secrutities. If cash was contributed, the ESOP was required to apply the cash to purchase employer securities within 30 days after the contribution. The employer's contribution to the ESOP could be made for the taxable year for which the investment tax credit is earned or as late as the taxable year for which the credit is claimed. In addition to the one-percent credit, up to one-half percent of extra investment tax credit was allowed where an employer contributed the extra amount to the tax credit ESOP and the employer's extra contribution was matched by employee contributions.

Under prior law, the rules allowing an employer the additional investment tax credit for ESOP contributions were to expire with respect to qualifying investments made after December 31, 1983.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 321-328; S. Rep. No. 97-144 (July 6, 1981), pp. 119-123; Senate floor amendments, 127 Cong. Rec. S7972-83 (july 20, 1981), S8626-29 (July 28, 1981), and S8945 (july 31, 1981) (daily ed.); and H. Rep. No. 97-215 (August 1, 1981), pp. 244-245 (Joint Explanatory Statement of the Committee of Conference).

[1] The plan may consist of a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan.

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Leveraged ESOPs

An employee stock ownership plan which borrows to acquire employer stock is referred to as a leveraged ESOP. Under a leveraged ESOP, the employer is allowed a deduction, within limits, for contributions to the plan which may be applied by the plan to service the loan.

Under prior law, the deduction allowed an employer for contributions to a profit-sharing or stock bonus plan (including a leveraged ESOP) generally was limited to 15 percent of the aggregate compensation of all employees under the plan.

In the case of a leveraged ESOP consisting of a stock bonus plan and a money purchase pension plan, the deduction for contributions to qualified plans for a year was limited to 25 percent of the aggregate compensation of employees covered by the plans. In addition, prior law provided that the annual contributions and certain other additions (including forfeitures) credited to a participant's account under qualified defined contribution plans of an employer (including a leveraged ESOP) generally could not exceed the lesser of $41,500 for 1981 ($25,000 adjusted for inflation since 1974) or 25 percent of the participant's compensation. In the case of certain ESOPs, the dollar limit is doubled.

Distributions from ESOPs

Employer securities allocated to an employee's account under a tax credit ESOP generally may not be distributed from the account before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or disability.

In addition, a participant in a leveraged ESOP or a tax credit ESOP who is entitled to a distribution under the plan is required to be provided the right to demand that the distribution be made in the form of employer securities rather than in cash. Subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest in cash, in employer securities, or partially in cash and partially in employer securities.

A participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option on the distributed employer securities if the securities are not readily tradable. Under prior law, the distributee was to be given up to six months after receipt of the securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option, the option will temporarily lapse. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities (in accordance with Treasury regulations) as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. Under prior law, such distributee was then given up to three months to require that the employer repurchase the employer

securities. If the distributee did not exercise this put option, the option permanently lapsed.

Because a participant might wish to transfer a distribution from a tax credit ESOP or leveraged ESOP to an IRA in a tax-free rollover, and because the transfer would have to be made before the expiration of the first six-month put option, an IRA trustee or custodian must be able to exercise the same put option as the participant.

Voting rights on employer securities

A tax-qualified defined contribution plan (including a profit-sharing plan, stock bonus plan, or ESOP) which is established by an employer whose securities are not publicly traded and which, following any acquisition of employer securities after 1979, holds more than ten percent of its assets in employer securities must provide that a plan participant is entitled to exercise voting rights with respect to employer securities allocated to the participant's account on any corporate issue which must by law (or charter) be decided by more than a majority vote of outstanding common shares voted on the issue.

Reasons for Change

The Congress concluded that experience in the operation of the tax laws applicable to employee stock ownership plans indicated that several changes were appropriate. The Congress was concerned that the investment-based tax credit for ESOPs provided too little incentive for the establishment of ESOPs by labor-intensive corporations, and concluded that a payroll-based tax credit would provide a more effective incentive.

In addition, the rules in prior law which limited the ability of a leveraged ESOP to acquire employer securities with the proceeds of a loan to the plan proved too restrictive and prevented the effective use of leveraged ESOPs as a technique of corporate finance. Certain of the provisions governing distributions to participants under a tax credit ESOP or leveraged ESOP proved burdensome and, in some cases, precluded an employer from establishing an employee stock ownership plan.

The Congress also concluded that the requirement relating to voting rights under profit-sharing plans was inappropriate because profit-sharing plans are not necessarily designed to further employee stock ownership.

Explanation of Provisions

Payroll-based tax credit

Termination of investment-based credit

The additional investment tax credit allowed an employer for contributions to a tax credit ESOP is terminated with respect to qualifying investments made after December 31, 1982. With respect to qualifying investments made after December 31, 1981, and before January 1, 1983, an employer is allowed a partial additional investment tax credit (i.e., an additional credit not in excess of one

percent), if the employer contributes an amount equal to the additional credit to a tax credit ESOP.

New payroll-based credit

For taxable years ending after December 31, 1982, in lieu of the additional investment tax credit, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

No payroll-based credit is allowed for contributions to a plan if more than one-third of the employer's contributions for the year is allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than ten percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit (for 1981, $83,000).

Limitations, requirements

The amount of the employer's income tax liability that can be offset by the payroll-based tax credit for contributions to a tax credit ESOP generally is limited to the first $25,000 of tax liability, plus 90 percent of the excess over $25,000. If the employer is a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied is reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations. If the tax credit otherwise allowed for ESOP contributions exceeds the amount of tax liability against which the credit may be applied for a taxable year, the unused tax credit may be carried back to each of the three preceding taxable years and carried forward to each of the 15 succeeding taxable years. The amount of any unused credit which expires at the close of the last taxable year to which it may be carried is allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for employer contributions to qualified plans.

An employer is allowed a tax credit for ESOP contributions only if it establishes a plan which meets the Code's requirements for tax credit ESOPs and agrees to transfer employer securities to the plan having a total value not more than the applicable percentage of the compensation of all employees under the plan. In addition, the employer must agree to transfer the securities not later than 30 days after the due date (including extensions) for filing the return for the taxable year for which the credit is earned (without regard to whether the credit is applied to offset the employer's income tax liability for that taxable year). For purposes of the tax credit ESOP rules, a contribution of cash to an ESOP is treated as a transfer of employer securities if the plan uses the cash within 30 days to purchase employer securities.

Deductible contributions to leveraged ESOPs

Amounts contributed by an employer to a leveraged ESOP and applied by the plan to the payment of interest on a loan incurred to purchase employer securities are allowed as a deduction to the employer without regard to an annual percent-of-compensation limit. The deduction allowed the employer for contributions applied to the payment of loan principal (but not interest) is limited to 25 percent of the compensation of all employees under the plan.

In addition, the employer's deductible ESOP contributions which are applied by the plan to the payment of interest on a loan to acquire employer securities, as well as any forfeitures of employer securities purchased with loan proceeds, generally are not taken into account under the rules providing overall limits on contributions and benefits under qualified plans. However, the rule allowing the employer contributions of loan interest and the employee forfeitures to be disregarded for purposes of the overall limitations will apply only if no more than one-third of the employer's contributions for the year is allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than ten percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit.

Under the Act, a forfeiture of an employer security is disregarded for purposes of the overall limitations on contributions and benefits only if the security's entire purchase price was paid with the proceeds of a loan to the ESOP. For this purpose, if a unit of employer securities is purchased by an ESOP partly with the proceeds of a loan and partly with other amounts, those securities having an aggregate value not in excess of the applied loan proceeds are treated as having been purchased only with the loan proceeds.

Distributions from ESOPs

An additional exception is made to the rule in present law which provides that employer securities allocated to an employee's account under a tax credit ESOP generally may not be distributed before the end of the 84th month after the month in which the securities are so allocated.

Under the Act, the 84-month rule does not apply in the case of the direct or indirect transfer of a participant from the employment of a selling corporation to the employment of an acquiring employer where all (or substantially all) of the assets used by the selling corporation in a trade or business are sold to the acquiring employer. The 84-month rule is also waived for an employee of a subsidiary of the selling corporation, with respect to securities of the selling corporation, where the selling corporation disposes of its interest in the subsidiary and the employee continues in the employ of the subsidiary.

In addition, a tax credit ESOP or a leveraged ESOP may preclude a participant from demanding a distribution in the form of employer securities if the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. The

ESOP must, however, provide that participants entitled to a distribution have a right to receive the distribution in cash.

In the case of a tax credit ESOP or a leveraged ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception is made to the rule generally requiring that a participant who receives a distribution of employer securities must be given a put option if the securities are not readily tradable. No put option is required if the ESOP provides that participants entitled to a distribution from the plan have a right to receive the distribution in cash. In addition, where a put option on distributed employer securities is required under present law, the employer may provide the option for a period of at least 60 days (rather than six months) following the date of the distribution and for an additional period of at least 60 days (rather than three months) in the following plan year.

A qualified stock bonus plan which is not a tax credit ESOP or a leveraged ESOP is permitted to provide a cash distribution option to participants if (1) a participant has a right to demand that plan benefits be distributed in the form of employer securities and (2) a participant who receives a distribution of employer securities which are not readily tradable is given a put option on the securities (under the rules applicable to tax credit ESOPs and leveraged ESOPs).

Voting rights on employer securities

The prior-law requirement that a plan participant generally be entitled to vote employer securities allocated to the participant's account under a defined contribution plan of an employer whose stock is not publicly traded is deleted for profit-sharing plans with respect to employer securities acquired by the plan after 1979. The prior-law rules remain applicable to all other defined contribution plans, including ESOPs.

Effective Date

These provisions generally apply to taxable years beginning after December 31, 1981. The termination of the additional investment tax credit for contributions to a tax credit ESOP is effective with respect to qualifying investments made after December 31, 1982. The payroll-based tax credit for ESOP contributions applies with respect to compensation paid or accrued after December 31, 1982, and before January 1, 1988.

The provisions under which employer contributions to, and forfeitures under, a leveraged ESOP are disregarded for purposes of the overall limitations on contributions and benefits, apply to years beginning after December 31, 1981. The provision relating to the 84-month rule for tax credit ESOPs applies to distributions made after March 29, 1975, and the provision relating to voting rights on employer securities applies to securities acquired after December 31, 1979.

Revenue Effect

These provisions are estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $61 million in 1983, $627 million in 1984, $1,548 million in 1985, and $2,298 million in 1986.

TITLE IV.—ESTATE AND GIFT TAX PROVISIONS

A. Increase in Unified Credit; Rate Reduction; Unlimited Marital Deduction

1. Increase in unified credit (sec. 401 of the Act and secs. 2010, 2505, and 6018 of the Code)*

Prior Law

The estate and gift taxes are unified, so that a single progressive rate schedule is applied to cumulative gifts and bequests. Under prior law, the estate and gift tax rates ranged from 18 percent on the first $10,000 of taxable transfers to 70 percent on taxable transfers in excess of $5 million.

Generally, estate or gift tax liability is determined by first computing the gross gift or estate tax and then subtracting the unified credit to determine the amount of the gift or estate tax.[1] The amount of the prior unified credit was $47,000. With a unified credit of $47,000, there was no estate or gift tax on transfers of up to $175,625.

The unified credit applicable to the estates of nonresident aliens is $3,600.

Reasons for Change

Under prior law, with a unified credit of $47,000, cumulative transfers of $175,625 could be made without the imposition of any transfer taxes. The amount of the credit was intended to exempt small- and moderate-sized estates from the estate and gift taxes. However, inflation has been increasing the estate and gift tax burdens by eroding the value of the credit and pushing estates and gifts into higher transfer tax brackets. In addition, the Congress determined that the amount of the prior credit, established in 1976 and fully effective in 1981, was inadequate to provide relief for estates containing farms, ranches, and small businesses which often were forced to dispose of family businesses to pay the estate or gift tax.

The Congress concluded that the unified credit should be increased to offset the effects of inflation and to provide estate and gift tax relief to small- or moderate-sized estates, especially those which primarily consist of family businesses.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 401; S. Rep. No. 97-144 (July 6, 1981), pp. 124-125; H.R. 4242, as reported by the House Ways and Means Committee, sec. 401; H. Rep. No. 97-201 (July 24, 1981), pp. 154-155; H.R. 4242, as passed by the House (July 29, 1981), sec. 401; and H. Rep. No. 97-215 (August 1, 1981), p. 247 (Joint Explanatory Statement of the Committee of Conference).

[1] However, the amount of the estate tax would be reduced further by other credits allowed to an estate.

Explanation of Provision

Increase in credit

The Act gradually increases the amount of the unified credit from $47,000 to $192,800 over a six-year period. When the unified credit reaches $192,800, there will be no estate or gift tax on transfers aggregating $600,000 or less.

The amount of the credit is $62,800 for estates of decedents dying, and gifts made, in 1982; $79,300 in 1983; $96,300 in 1984; $121,800 in 1985; $155,800 in 1986; and $192,800 in 1987 and subsequent years.

The Act makes no changes to the unified credit for nonresident aliens.

Filing requirements

The Act also revises the estate tax filing requirements to reflect the increased unified credit amount. When the credit is phased in fully, the Act requires that an estate tax return be filed only if the decedent's gross estate exceeds $600,000. During the five year phase-in period, the filing requirements are to be $225,000, $275,000, $325,000, $400,000 and $500,000 in 1982, 1983, 1984, 1985, and 1986, respectively.

As under prior law, the threshold filing requirement will be reduced (but not below zero) by the sum of the adjusted taxable gifts made by the decedent after December 31, 1976, and the amount of the specific gift tax exemption under the law prior to the Tax Reform Act of 1976 which may have been used by the decedent with respect to gifts made after September 8, 1976, and before January 1, 1977.

Effective Date

The provision applies to estates of decedents dying after December 31, 1981, and to gifts made after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $1,077 million in 1983, $1,981 million in 1984, $2,811 million in 1985, and $3,834 million in 1986.

2. Rate Reduction (sec. 402 of the Act and sec. 2001 of the Code)*

Prior Law

Under the unified estate and gift tax rate schedule of prior law, rates ranged from 18 percent on the first $10,000 of taxable transfers to 70 percent on taxable transfers in excess of $5 million.[1]

Reasons for Change

Despite the substantial increase in the unified credit and the more liberal installment payment provisions of the Act, the prior law estate and gift tax rates could result in the imposition of larger estate and gift taxes on estates containing highly successful closely held and family businesses than their owners could afford without disposing of the businesses. To help prevent forced sales of closely held and family businesses in order to pay those estate and gift taxes, the Congress determined that the maximum rates of estate and gift taxes should be reduced from 70 percent to 50 percent. In addition, the Congress concluded that a maximum estate and gift tax rate of 50 percent would be consistent with the provision of the Act which reduces the maximum rate of income taxes to 50 percent.

Explanation of Provision

The Act reduces the maximum estate and gift tax rate from 70 percent to 50 percent over a four-year period.

The maximum rate is 65 percent for estates of decedents dying, and gifts made, in 1982; 60 percent in 1983; 55 percent in 1984; and 50 percent in 1985 and subsequent years. The maximum rate applies to transfers in excess of $4,000,000 in 1982; $3,500,000 in 1983; $3,000,000 in 1984; and $2,500,000 in 1985 and subsequent years.

As under prior law, the estate tax is computed first by determining the gross estate tax and then subtracting the gift taxes payable on gifts made after 1976 (sec. 2001(b)). In order to prevent the change in rates from applying retroactively to gifts made prior to 1985, the reduction allowed under section 2001(b) for gift taxes attributable to gifts made after December 31, 1976, will be the amount of tax which would have been payable had the gifts been subject to the rate schedule in effect upon the decedent's death. For example, if a decedent dying in 1982 made a post-1976 gift which was entirely subject to tax at the highest marginal gift tax rate of

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 402; H. Rep. No. 97-201 (July 24, 1981), pp. 156-157; H.R. 4242, as passed by the House (July 29, 1981), sec. 402; and H. Rep. No. 97-215 (August 1, 1981), p. 247 (Joint Explanatory Statement of the Committee of Conference).

[1] Prior to the Tax Reform Act of 1976, there were separate rate schedules for the estate tax and the gift tax. The gift tax rates were approximately three-fourths of the estate tax rates. The Tax Reform Act of 1976 combined the separate rate schedules into a unified transfer tax rate schedule.

70 percent, the amount of the credit for gift taxes paid will be computed using the maximum rate in effect at his death (i.e., 65 percent under the Act). A similar rule already was provided in prior law for gift tax purposes.

Effective Date

The provision applies with respect to gifts made, and estates of decedents dying, after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $172 million in 1983, $371 million in 1984, $556 million in 1985, and $890 million in 1986.

3. Unlimited marital deduction (sec. 403 of the Act and secs. 2040, 2044, 2056, 2207A, 2515, 2515A, 2519, 2523, and 6019 of the Code)*

Prior Law

Marital deduction

Prior law allowed a limited deduction for gifts and bequests between spouses. Under prior law, a gift tax marital deduction was allowed for the entire value of first $100,000 of transfers between spouses. Thereafter, a deduction was allowed for 50 percent of interspousal lifetime transfers in excess of $200,000. In addition, an estate tax marital deduction generally equal to the greater of $250,000 or one-half of the decedent's adjusted gross estate was allowed for the value of property passing from a decedent to the surviving spouse. This amount was adjusted by the excess of the amount of the unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interests did not qualify for either the gift or estate tax marital deductions. Terminable interests generally are created where an interest in property passes to the spouse and another interest in the same property passes from the donor or decedent to some other person for less than adequate consideration.[1]

Jointly held property

The prior estate and gift tax provisions contained several special rules governing the treatment of jointly held property for estate and gift tax purposes. These rules applied to forms of ownership where there was a right of survivorship upon the death of one of the joint tenants. They did not apply to community property or property owned as tenants in common.

Under prior law, the creation of a joint tenancy was generally considered a completed gift for gift tax purposes. The amount of the taxable gift depended upon whether the right of survivorship could be defeated by either tenant unilaterally under applicable local law. If either tenant, acting alone, could require a severance of the tenancy, the amount of the gift was one-half of the value of the jointly held property. However, if the right of survivorship could not be terminated except by the mutual consent of the tenants, then the value of the gift varied with the relative ages of the tenants in order to reflect the fact that the younger tenants had a

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 402; S. Rep. No. 97-144 (July 6, 1981), pp. 126-128; Senate floor amendment, 127 Cong. Rec. S 8345-8346 (daily ed. July 24, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 403; H. Rep. No. 97-201 (July 24, 1981), pp. 158-164; H.R. 4242, as passed by the House (July 29, 1981), sec. 403; and H. Rep. No. 97-215 (August 1, 1981), p. 247 (Joint Explanatory Statement of the Committee of Conference).

[1] For example, the gift of an income interest by a donor to his spouse would not qualify for the marital deduction where the remainder interest was transferred by the donor to a third party.

more valuable interest because the younger tenants would have a greater probability of surviving and taking all of the property.

In addition, under these rules, the gross estate included the entire value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party (sec. 2040 (a)). The decedent's estate had the burden of proving that the other joint owner, or owners, acquired their interest for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, did not include money or property shown to have been acquired from the decedent for less than full and adequate consideration in money or money's worth.

In addition, special rules were provided for (1) certain qualified joint interests held by a decedent and his spouse (secs. 2515, 2515A, 2040(b), (d) and (e)) and (2) certain jointly held property used in a farm or other trade or business in which both spouses materially participated (sec. 2040(c)).

For gift tax purposes, section 2515 provided an exception to the general rule that the creation of a joint tenancy resulted in a taxable gift. Under that section, the creation of a joint tenancy (or a tenancy by the entirety) by a husband and his wife in real property was not treated as a taxable gift at the time of the creation, unless the donor elected otherwise. If the election was not made, a taxable gift was considered to be made upon termination of the joint tenancy to the extent that either spouse received property interests or proceeds exceeding those attributable to the consideration furnished by that spouse.

The Tax Reform Act of 1976 modified the estate and gift taxation of jointly held property between spouses in a number of ways. First, where the donor elected to treat the creation of jointly held real property between husband and wife as a taxable gift at the creation of the tenancy, the amount of the gift was equal to one-half the value of the property regardless of whether the joint tenancy is severable without the mutual consent of spouses (sec. 2515(c)). This rule was applied by the 1976 Act and subsequent legislation (1) to tenancies created after December 31, 1976, (2) to tenancies created before January 1, 1977, which were severed and recreated after that date (sec. 2040(e)), and (3) to certain tenancies which the donor elected to treat as having been constructively severed and recreated during 1977, 1978, or 1979 (sec. 2040(d)). Second, the Act applied the same rule to joint tenancies created by spouses in personal property (sec. 2515A). Finally, with respect to joint tenancies created (or deemed created under the rule above) after December 31, 1976, only one-half of the value of the jointly held property was included in the gross estate of the first spouse to die regardless of the amount of consideration furnished by that spouse (sec. 2040(b)).

The Revenue Act of 1978 provided a special rule (sec. 2040 (c)) under which spouses materially participating in the operation of a farm or other trade or business were deemed to have furnished consideration for the acquisition of the farm or business generally

equal to two percent of the appreciation in the property per year of material participation (not to exceed 50 percent).

Reasons for Change

Marital deduction

Because the maximum estate tax marital deduction generally was limited (under prior law) to one-half of a decedent's adjusted gross estate, the estate of a decedent who bequeathed his or her entire estate to the surviving spouse was often subject to estate taxes even though the property remained within the marital unit. When the surviving spouse later transferred the property (often to the children), the entire amount was subject to transfer taxes. The cumulative effect was to subject their property to tax one and one-half times, i.e., one-half upon the death of the first spouse and again fully upon the death of the second spouse. This effect typically occurred in the case of jointly held property. Because this additional tax fell most heavily on widows, it was often referred to as the "widow's tax."

Although the Congress recognized that this additional tax could be minimized through proper estate planning,[2] it believed that an individual generally should be free to pass his or her entire estate to a surviving spouse without the imposition of any estate tax. For similar reasons, the Congress believed it appropriate generally to permit unlimited lifetime transfers between spouses without the imposition of any gift taxes.

In addition, the Congress determined that substantial simplification of the estate and gift taxes would be achieved by allowing an unlimited deduction for transfers between spouses. Under prior law, it was often extremely difficult to determine the ownership of property held within the marital unit and to determine whose funds were used to acquire that property. These problems generally will not arise with an unlimited marital deduction.

The Congress determined that the present limitations on the nature of interests qualifying for the marital deduction should be liberalized to permit certain transfers of terminable interests to qualify for the marital deduction. Under prior law, the marital deduction was available only with respect to property passing outright to the spouse or in specified forms which gave the spouse control over the transferred property. Because the surviving spouse had to be given control over the property, the decedent could not insure that the spouse would subsequently pass the property to his children. Because the maximum marital deduction generally was limited under prior law to one-half of the decedent's adjusted gross estate, a decedent could only control disposition of one-half of his or her estate and still maximize the then current tax benefits. However, unless certain interests which do not grant the spouse total control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of

[2] For example, most estate planners divided the estate into two equal portions, leaving one-half of the estate to the surviving spouse in a form that qualified for the marital deduction and the other half to the surviving spouse and/or the descendants in a form which did not qualify for a marital deduction. Under such an arrangement, the nonqualifying half was taxed at the death of the decedent, and the qualifying half was subsequently taxed at the death of the surviving spouse. Consequently, the entire amount of the property was taxed only once.

the entire estate to avoid imposition of estate tax at his death or reducing tax benefits at death to insure inheritance by his legatees. The Congress believed that the transfer tax consequences should not unduly influence how an individual disposes of his property. Accordingly, the Congress determined that a deduction should be permitted for certain terminable interests.

Nevertheless, the Congress decided that property subject to terminable interests qualifying for the marital deduction should be taxable, as under prior law, upon the death of the second spouse (or, if earlier, when the spouse disposes of the terminable interest in such property). Though the Congress believed that qualifying terminable interest property should be aggregated with the spouse's cumulative gifts or included in the spouse's estate to determine the amount of the transfer tax, it did not believe that the spouse or the spouse's heirs should bear the burden of this tax. Accordingly, the Congress believed it appropriate to provide an apportionment rule to insure that any transfer taxes imposed on qualified terminable interest property are borne by the persons receiving that property and not by the spouse or the spouse's heirs.

Jointly held property

The Congress believed that rules governing the taxation of jointly held property between spouses were unnecessarily complex. In particular, the Congress recognized that it is often difficult, as between spouses, to determine the amount of consideration that each spouse provided for the acquisition and improvement of their jointly held property. Further, because few taxpayers understand the gift tax consequences of joint ownership, there was widespread noncompliance.

In view of the unlimited marital deduction adopted by the Act, the taxation of jointly held property between spouses will be relevant only for determining the basis of property to the survivor (under sec. 1014) and the qualification for certain provisions (such as current use valuation under sec. 2032A, deferred payment of estate taxes under sec. 6166, and for income taxation of redemptions to pay death taxes and administration expenses under sec. 303). Accordingly, the Congress believed it appropriate to adopt an easily administered rule under which each spouse is considered to own one-half of jointly held property, regardless of which spouse furnished the original consideration.

Explanation of Provision

Marital deduction

Removal of quantitative limits

The Act removes the quantitative limits on the marital deduction for both estate and gift tax purposes. Thus, unlimited amounts of property (other than certain terminable interests) may be transferred between spouses without estate or gift tax. The Act deletes the provisions of prior law which disallow the marital deduction for transfers between spouses of community property.

Qualified terminable interest property

Under the Act, certain transfers of qualified terminable interest property qualify for the marital deduction. If certain conditions are met, a surviving spouse's income interest in qualified terminable interest property is not treated as a terminable interest. The entire property subject to such interest is treated as passing to the spouse, and no interest in such property is considered to pass to any person other than the spouse. Accordingly, the entire property qualifies for a marital deduction.

In general, qualified terminable interest property is property which passes from the donor or decedent in which the spouse receives a qualifying income interest for life and for which an irrevocable election is made to treat the property as qualified terminable interest property.

Election.—For gift tax purposes, the election must be made on a gift tax return filed by the donor or any person authorized to act on his behalf. Thus, although the Act generally exempts interspousal transfers eligible for the marital deduction from the gift tax filing requirements, a return is still required for transfers of qualified terminable interest property. The election is irrevocable once made. For estate tax purposes, the election must be made by the executor on the estate tax return and is irrevocable once made. This election can be made by the executor whether or not the decedent's will instructs the executor to make the election.

Qualifying income interests.—A qualifying income interest must meet several conditions. First, the interest passing from the decedent must entitle the spouse for a period measured solely by the spouse's life to all the income from the entire property or all the income from a specific portion thereof, payable annually or at more frequent intervals. Thus, income interests granted for a term of years, or life estates subject to terminaton upon remarriage, or the occurrence of a specified event, are not qualifying income interests. A qualifying income interest for life in any property must provide the spouse with a degree of beneficial enjoyment sufficient to satisfy the rules applicable to marital deduction trusts under Treas. Reg. §20.2056 (b)–5(f). The Act does not limit qualifying income interests to those placed in trust. However, the Congress intended that the rules applicable to interests not in trust be similar to the rules applicable to qualifying income interests which are in trust.

Second, there must be no power in any person (including the spouse) to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse's life. This rule permits the existence of powers in the trustee to invade corpus for the benefit of the spouse (whether or not subject to any standards), but insures that the value of the property not consumed by the spouse is subject to tax upon the spouse's death (or earlier disposition). The Act permits the creation or retention of any powers exercisable in favor of any person over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse.

However, this rule does not require that the spouse be denied the right to dispose of her income interest. For example, the spouse may be permitted to dispose of all or a part of the qualifying income interest, although such disposition will subject the property

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to transfer taxes (See discussion of subsequent tax treatment below). Similarly, this rule does not prohibit the transfer of a remainder interest, provided that the spouse's income interest is not affected by the transfer.

Subsequent tax treatment

The Act provides that the entire value of property subject to an election to be treated as a qualified terminable interest will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or any part of the qualifying income interest or (2) upon the spouse's death.

If the property is subject to tax as a result of the spouse's lifetime disposition of all or any part of the qualifying income interest, the spouse is treated as having made a taxable gift of the entire value of the remainder interest in the qualified terminable interest property or specific portion of qualified terminable interest property under new section 2519. In addition, the value of any qualifying income interest transferred by gift by the spouse would also be a taxable gift. The gift of all or any of the qualifying income interest would qualify for the annual gift tax exclusion (sec. 2503). However, the imputed gift of the remainder interest would qualify for the gift tax annual exclusion only to the extent that the qualifying income interest is transferred to the remaindermen (because it would otherwise be a future interest).

For purposes of determining whether the donee-spouse has disposed of all or any portion of a qualifying income interest, the Congress intended that the conversion of qualifying terminable interest property into other qualifying terminable interest property will not be considered a disposition of the qualifying income interest. For example, the sale and reinvestment of assets of a trust which meets the requirements of qualified terminable interest property will not be considered a disposition of the qualifying income interest. Similarly, the sale of real property which met the requirements of qualified terminable interest property, followed by the transfer of the proceeds into a trust which also meets the requirements of qualified terminable interest property, will not be considered a disposition of the qualifying income interest. However, to the extent that qualified terminable interest property is disposed of and not converted into other qualified terminable interest property, the donee-spouse will be treated as having made a gift of the remainder interest. For example, if a court ordered the termination of a trust containing qualified terminable interest property prior to the donee-spouse's death and distributed the trust assets to the donee-spouse and the remaindermen, the donee-spouse would be treated as making a gift of the entire value of the remainder interest under section 2519.

If the property subject to the qualifying income interest is not deemed to be transferred prior to the death of the surviving spouse, the estate tax value of the property subject to the qualifying income interest is included in the spouse's gross estate pursuant to new section 2044.[4]

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[4] The Congress intended that qualified terminable interest property included in the spouse's gross estate pursuant to section 2044 be treated as passing from the spouse. Thus, for example, it was intended that such property be treated as passing from the spouse for purposes of determining the remaindermen's basis under section 1014, the availability of current use valua-

Because qualified terminable interest property will either be included in the donee-spouse's gross estate (under sec. 2044) or be treated as a gift by that spouse (under sec. 2519), the Congress intends that qualified terminable interest property be treated for transfer tax purposes as if the entire property had been transferred to the donee-spouse. Nevertheless, the Congress was aware that, where the donor-spouse retains an interest or power in the qualified terminable interest property and the donor subsequently transfers the power or interest prior to the deemed transfer by the donee-spouse under sections 2044 or 2519, the transfer might be subject to gift tax. Similarly, where the donor-spouse retained an interest or power in the qualified terminable interest property until his death, all or a portion of the qualified terminable interest property might be includible in his gross estate. The donor-spouse or his estate would be so taxable even though the qualified terminable interest property also would be treated as transfer by the under sections 2044 or 2519. In order to preclude this result, the Congress intends that any retained interest or power which the donor-spouse transfers, or dies owning, prior to a deemed transfer by the donee-spouse under sections 2044 or 2519 should not be treated as a gift or be included in the donee-spouse's gross estate.

Other rules

The Act also provides apportionment provisions under which the additional estate and gift taxes attributable to the taxation of the qualified terminable interest property are borne by the persons receiving the property. Unless the donee-spouse directs otherwise by will, the donee-spouse's estate is granted a right to recover the estate tax paid as a result of including such property in the donee-spouse's estate from the person or persons receiving such property.

Similarly, where the remainder interest is subject to gift taxes as a result of the donee-spouse's lifetime disposition of all or any part of the qualifying income interest, the spouse is granted a right to recover such gift taxes from the person or persons receiving the property. If the donee-spouse waives the right to recover the gift taxes attributable to the remainder interest, the amount of the gift taxes will be treated as a taxable transfer from the spouse to the person or persons receiving the remainder interest.

Under the Act, if there is more than one person receiving the property, each recipient will be jointly and severally liable for the entire amount of such estate or gift tax. In addition, this right of recovery extends to any penalties or interest paid which are attributable to the additional estate or gift taxes. If, however, the inclusion of the property in the donee-spouse's estate or the taxation of

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tion under section 2032A, the availability of a charitable deduction under section 2055, the availability of a marital deduction under section 2056, and eligibility for installment payment of the estate taxes attributable to interests in closely held businesses under section 6166.

However, for purposes of section 2518 (which provides generally that a qualified disclaimer must be made within nine months of the taxable transfer creating the interest to be disclaimed), the transfer date is the date on which the donor or decedent created the interests in qualified terminable interest property, notwithstanding the fact that, because such property is eligible for a marital deduction, the value of the interest may not be taxed until a later date (secs. 2044 and 2519). Thus, to make a qualified disclaimer of a remainder interest in qualified terminable interest property, an individual must disclaim within nine months of the transfer creating the interest, rather than nine months of the date such interest is subject to tax under sections 2044 or 2519. Nonetheless, the period for making the disclaimer does not expire until nine months after the date on which the person making the disclaimer has attained age 21.

the remainder interest as a result of a lifetime disposition of all or any part of the qualifying income interest uses up some or all of the donee-spouse's unified credit, the Act does not permit the donee-spouse's estate or the donee-spouse to recover an amount equal to the applied credit from the person or persons receiving that property.

Charitable gifts

If an individual transfers property outright to charity, no transfer taxes generally are imposed. Similarly, under the unlimited marital deduction provided in the Act, no tax generally is imposed on an outright gift to the decedent's spouse. As a result, the Congress concluded that there is no justification for imposing transfer taxes on certain transfers split between a spouse and a qualifying charity. Accordingly, the Act provides a special rule for transfers of interests in the same property to a spouse and a qualifying charity.

Under the Act, if an individual creates a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust, and the only noncharitable beneficiaries are the donor and the donor's spouse, the disallowance rule for terminable interests does not apply. Therefore, the individual receives a charitable deduction (under secs. 2055 or 2522) for the amount of the remainder interest and a marital deduction (under secs. 2056 or 2523) for the value of the annuity or unitrust interest; no transfer tax will be imposed.[5]

Gift tax filing requirements

Because an unlimited marital deduction is permitted for interspousal transfers, the Act generally exempts all transfers eligible for the marital deduction (other than transfers of qualified terminable interest property) from the gift tax filing requirements. Nevertheless, such transfers will be includible in the decedent's estate to the extent the rules on inclusion in a decedent's estate of gifts made within three years of death (under sec. 2035) still apply under the Act.[6]

Under the Act, gifts made within three years of death are includible in the gross estate only for certain purposes (set forth in sec. 2035(d)). Under section 2035 generally, gifts made within three years of death for which a gift tax return is not required are not includible in the gross estate. However, the Act amends this rule so that it does not exclude interspousal gifts for which a return is not required because of the marital deduction. Thus, all interspousal

[5] The general rules applicable to qualifying income interests may provide similar treatment where a decedent or donor provides an income interest in the spouse for the spouse's life and a remainder interest to charity. If the life estate is a qualifying income interest and an election is made to treat the property as qualified terminable interest property, the entire property will be considered as passing to the spouse. Therefore, the entire value of the property will be eligible for the marital deduction and no transfer tax will be imposed. Because the entire value of the property qualifies for the marital deduction, the Congress did not intend to allow a charitable deduction to the donor or decedent in addition to the marital deduction, even if the qualifying remainder interest otherwise qualifies for a charitable deduction (e.g., because it is a remainder interest in a pooled income fund within the meaning of sec. 642(c)(5)). On the spouse's death, the property will be included in the spouse's estate. However, the Congress intended that a charitable deduction be allowed to the spouse's estate for any interest in property passing to charity at the spouse's death which would otherwise qualify as a charitable transfer. For this purpose, the Congress intended that property included in the spouse's estate pursuant to sec. 2044 be treated as passing from the spouse. For other cases where the Congress intended that such property be considered as passing from the decedent, see footnote 4 above.

[6] See discussion below of estate tax treatment of transfers made within three years of death.

transfers made within three years of death (other than transfers which are less than the annual exclusion under sec. 2503(b)) will be included in a decedent's gross estate (without reduction for the amount of the annual exclusion) for the purposes specified in section 2035(d). The Congress considered this inclusion rule important to prevent a decedent from making deathbed interspousal transfers to qualify the estate for certain provisions which depend on the size and composition of the gross estate (e.g., secs. 303, 2032A, and 6166).

For example, for the purposes for which section 2035 still applies, a decedent's transfer of a present interest in property valued at $12,000 to a spouse within three years of death is fully includible in that decedent's gross estate (valued at its estate tax value). However, a transfer of property (other than transfers with respect to life insurance policies) valued at less than $10,000 is excluded, regardless of its estate tax value, because section 6019(a)(1) provides that no return is required for gifts less than the section 2503(b) annual exclusion.

Jointly held property

The Act provides special rules for determining the amount to be included in the gross estate in the case of property held by spouses in joint tenancy with a right of survivorship. Under the Act, the estate of the first spouse to die includes one-half of the value of the property regardless of which spouse furnished the consideration for the acquisition of the property. The Act also repeals certain of the special prior law rules applicable to the treatment of jointly held property between spouses (secs. 2040(c) to 2040(e), 2515, and 2515A).

Effective Date

In general, the changes with respect to the marital deduction apply with respect to gifts made, or estates of decedents dying, after December 31, 1981.

The Congress understood that many existing wills and trusts include a maximum marital deduction formula clause under which the amount of property transferred to the surviving spouse is determined by reference to the maximum allowable marital deduction. Because the maximum estate tax marital deduction under prior law was limited to the greater of $250,000 or one-half of the decedent's adjusted gross estate, the Congress was concerned that many testators, although using the formula clause, may not have wanted to pass assets valued at more than the greater of $250,000 or one-half of the adjusted gross estate (recognizing the prior law limitation) to the spouse—a result which might otherwise occur because of the enactment of an unlimited marital deduction. For this reason, a transitional rule provides that the increased estate tax marital deduction, as provided by the Act, does not apply to transfers resulting from a will executed or trust created before the date which is 30 days after the date of enactment (i.e., September 12, 1981), which contains a maximum marital deduction clause, provided that (1) the formula clause is not amended before the death of the decedent to refer specifically to an unlimited marital deduction and (2) there is not enacted a State law, applicable to the

estate, which would construe the formula clause as referring to the increased marital deduction as amended by the Act.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $303 million in 1983, $304 million in 1984, $311 million in 1985, and $300 million in 1986.

B. Other Estate Tax Provisions

1. Current use valuation of certain property (sec. 421 of the Act and secs. 1040 and 2032A of the Code)*

Prior Law

In general

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, family farms and real property used in other closely held businesses may be included in a decedent's estate at its current use value, rather than its full fair market value (sec. 2032A). Under prior law, the maximum reduction in the fair market value of such real property resulting from the current use valuation provision was $500,000.[1]

Qualification requirements

An estate may qualify for current use valuation if (1) the decedent was a citizen or resident of the United States at his death; (2) the adjusted value[2] of the farm or closely held business assets in the decedent's estate, including both real and personal property, is at least 50 percent of the adjusted value of the decedent's gross estate; (3) at least 25 percent of the adjusted value of the gross estate is comprised of the adjusted value of qualified farm or closely held business real property;[3] (4) the real property qualifying for current use valuation passes to a qualified heir;[4] (5) such real property has been owned by the decedent or a member of his family and used as a farm or closely held business ("a qualified use") for five years of the last eight years prior to the decedent's

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 404; S. Rep. No. 97-144 (July 6, 1981), pp. 131-137; H.R. 4242, as reported by the House Ways and Means Committee, sec. 421; H. Rep. No. 97-201 (July 24, 1981), pp. 165-179; H.R. 4242, as passed by the House (July 29, 1981), sec. 421; and H. Rep. No. 97-215 (August 1, 1981), pp. 247-254 (Joint Explanatory Statement of the Committee of Conference); and S. Con. Res. 30, 127 Con. Rec. S9270 (Aug. 3, 1981) and H5993 (Aug. 4, 1981) (daily ed.).

[1] The fair market value of specially valued property, as well as the property's current use value, must be determined for purposes of this limitation and other requirements under the provision. In most cases, however, the fair market value of specially valued property is significant only for determining the maximum potential amount of the recapture tax, which is not assessed unless certain post-death events occur. (The recapture tax is more fully discussed elsewhere in this section.) Since the issue of fair market value of specially valued property may not affect any presently assessable amount of tax where it is the only unresolved issue in an estate, there is no opportunity for judicial review of the issue unless the entire use valuation election is disallowed by the Treasury Department.

[2] The "adjusted value" of the gross estate (or of specific property) is its gross value less any mortgages or other indebtedness, payment of which are secured by an interest in the property included in the gross estate (or by the specific property).

[3] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[4] Under prior law, the term "qualified heir" meant a member of the decedent's family, including the spouse, lineal descendants, parents, grandparents, aunts, or uncles of the decedent and their descendants. The term did not include members of a spouse's family.

death and on the date of the death;[5] (6) there has been material participation in the operation of the farm or closely held business by the decedent or a member of his family for periods aggregating at least five years out of the eight years immediately preceeding the decedent's death;[6] (7) the executor makes an election within the time prescribed for filing the decedent's estate tax return; and (8) all parties with any interest in property to be specially valued enter into an agreement consenting to the election.[7]

Under prior law, property was considered to be acquired from a decedent only if the qualified heir received the property by bequest, devise, or inheritance. Property which was purchased from the decedent's estate by a qualified heir (or was subject to an option in a qualified heir to purchase it from the estate) passed by purchase rather than bequest, devise, or inheritance and could not, therefore, be specially valued.

Property owned indirectly through ownership of an interest in a partnership, a corporation, or a trust qualifies for current use valuation to the extent that it would qualify if it were owned directly.[8]

Valuation methods

The current use value of qualifed real property[9] may be determined under either of two methods: (1) the multiple factor method or (2) the formula method.

Multiple factor method

The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property without regard to any use other than its current use.

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[5] Under prior law, property which was acquired pursuant to an exchange under section 1031 (relating to nonrecognition of gain or loss on a like-kind exchange) or section 1033 (relating to nonrecognition of gain or loss on an involuntary conversion) was considered to be owned and used in a qualified use only from the date on which the replacement property was acquired.

[6] In the case of qualifying real property where the ownership, use, and material participation requirements are satisfied, the real property which qualifies for current use valuation includes the farmhouse, other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

[7] The required agreement must be binding under the law of the State in which each party resides. In many States, this requires that a *guardian ad litem* be appointed for minor heirs for the purpose of signing the agreement.

[8] Under prior law, property qualified for current use valuation only to the extent that an heir received a "present interest" in the property. The Treasury regulations defined the term "present interest" by reference to the gift tax law (sec. 2503). This definition precluded current use valuation of any property passing from the decedent to a trust in which the interest of the life tenant (or any other beneficiary whose interest became a present interest before expiration of the recapture period) was subject to discretion on the part of the trustee. This result was the same even if all potential beneficiaries of the trust were qualifed heirs (Reg. § 20.2032A-3(b)(1)).

[9] Under prior law, growing crops, including standing timber in the case of timber farms, were not treated as part of the qualified real property.

Formula method

If there is comparable land from which the average annual gross cash rental may be determined,[10] then farm property (but not property used in other trades or businesses) may also be valued under the formula method (sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for tracts of comparable land used for farming from the average annual gross cash rental for the tracts of comparable land, and (2) dividing that amount by the average annual effective interest for all new Federal land bank loans.[11]

The comparable property used by the executor to value the decedent's qualified real property under the formula method must be located in the same locality as the specially valued property. The determination of whether property is comparable is factual and is made on a case-by-case basis, with no single factor being conclusive. Different parcels of real property need not be exactly alike to be comparable, however. Comparability requires only that the different parcels be used in the same farming use and that the value of the parcels of property be equivalent or similar in that farming use.[12]

Recapture

If, within 15 years after the death of the decedent (and before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purpose based upon which it was valued in the decedent's estate, all or a portion[13] of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" or "recapture tax" imposed on the qualified heir.

Under prior law, failure by the heir or a member of the heir's family to materially participate in the business operation for periods aggregating three years or more during any eight-year period ending within the recapture period was treated as a cessation of qualified use. Prior law contained a special rule under which no additional estate tax was imposed where property had been involuntarily converted to the extent it was replaced by qualified property (under sec. 1033) and the heir made an election.[14]

If an election is made to value property based on its current use, the qualified heir's income tax basis in the property is the current

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[10] Under prior law, share rentals could not be converted to a cash equivalent to be used in the formula valuation method (Reg. § 20.2032A-4(b)(2)(iii)).

[11] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death (sec. 2032A(e)(7)(A)).

[12] In the case of specially valued property on which buildings and other improvements are located, similar improved property would be used.

[13] In the case of a disposition or cessation of qualified use of only part of an heir's interest in qualified property, the recapture tax is equal to the lesser of (1) the estate tax saved by the decedent's estate with respect to the heir's interest in specially valued property, or (2) the excess of the amount realized on the disposition (fair market value in cases other than arm's-length dispositions) over the pro rata portion of the special use value of the heir's interest represented by the property disposed of, etc., by the heir. The pro rata determination is made by reference to acres or other relevant land areas.

[14] On the other hand, a like-kind exchange (under sec. 1031) of specially valued real property resulted in imposition of the recapture tax unless the exchange was with a member of the qualified heir's family.

use value. Under prior law, no adjustment was made to this basis if the recapture tax was imposed.

Reasons for Change

The Congress believed that it is desirable to encourage the continued ownership and operation of farms and other small businesses by family units. If real property is actually used for farming purposes or in other closely held businesses by members of a family (both before and after the death of the owner of the property), the Congress believed that it is inappropriate to value the property for estate tax purposes based on a market value that does not reflect its value in its current use. Valuation on the basis of a use other than current use could result in forced liquidation of many family owned and operated businesses to pay Federal estate taxes and could also result in increased concentration of ownership of the real property necessary for the survival of these family businesses.

The current use valuation provision has provided extensive relief to numerous family farms and businesses. However, a number of technical requirements of prior law resulted in incomplete relief being received by the owners of many family farms and other businesses which the Congress wished to aid. Additionally, the Congress concluded that substantive changes to the provision were needed in some instances to insure that the full relief available under the provision is received by its intended beneficiaries. For these reasons, the Congress provided a number of changes to the current use valuation provision to assist further in the preservation of family owned and operated farms and other businesses.

Explanation of Provision

Overview

The Act makes numerous technical changes in the current use valuation provision as well as several substantive changes affecting each of the major areas of the provision: pre-death qualification requirements, election requirements, valuation rules, and post-death recapture rules. The Act also provides special rules for current use valuation of woodlands.

These changes generally expand availability of current use valuation to estates not eligible under prior law, enable additional estates to satisfy the election requirement, enable additional farm estates to take advantage of the formula valuation method included in the provision, and reduce the post-death restrictions on qualified heirs inheriting specially valued real property. Some of the technical changes apply retroactively to certain estates of decedents dying after December 31, 1976.

Changes to pre-death qualification requirements

Qualified use requirement

To facilitate the orderly transfer of responsibility for farming operations before death, the Act provides that the qualified use requirement, applicable to periods on and before the date of the decedent's death (sec. 2032A(b)(1)), may be satisfied if either the decedent or a member of the decedent's family uses real property

otherwise eligible for current use valuation as a farm for farming purposes (including a timber farming operation) or in another trade or business.[15] The Act does not change the requirement that this use be an active trade or business use as opposed to a passive, or investment, use.

For example, if a decedent leased otherwise qualified real property to a son pursuant to a net cash lease,[16] and the son conducted a farming operation on the property, the son's business use is attributed to the decedent for purposes of satisfying the pre-death qualified use requirement (sec. 2032A(b)(1)). Likewise, if the decedent permitted a member of his family to use the property in a qualified use for the required pre-death periods, without paying any rent, the qualified use requirement would be satisfied. During any periods when the property is leased to a nonfamily member pursuant to a net cash lease, or during which a nonfamily member uses the property without paying any rent (or pays a rent that is less than a fair market rental), the qualified use requirement is not satisfied.

The Act does not change the present requirement that the qualified heir owning the real property after the decedent's death must personally use it in the qualified use throughout the recapture period (except during the two-year period immediately following the decedent's death, discussed below).

Material participation requirement

Time periods.—Under prior law, the decedent or a member of the decedent's family had to materially participate in the farm for periods aggregating five years or more of the eight years immediately before the decedent's death. On the other hand, if the decedent materially participated in the farm, any income derived from the farm was treated as earned income for social security purposes and, therefore, could reduce the decedent's social security benefits.

Because of the interaction of these two rules, some older citizens were forced to choose between receiving social security retirement benefits and securing the benefits of current use valuation for their estates. In addition, some individuals become disabled and are not able to materially participate in the operation of the farm or other trade or business. To alleviate the problem encountered by these individuals, the Act changes the time periods before the decedent's death when the decedent (or a member of the decedent's family) must materially participate in the operation of the farm or other trade or business where the decedent was disabled or was receiving social security retirement benefits on the date of his or her death. However, no change is made to the time periods when the pre-death qualified use requirement, discussed above, must be satisfied.

Under the Act, the material participation requirement has to be satisfied during periods aggregating five years or more of the eight-year period ending before the earlier of (1) the date of the decedent's death, (2) the date on which the decedent became disabled

[15] This amendment applies retroactively to certain estates of decedents dying after December 31, 1976. A complete explanation of this retroactive effect is included in the "Effective Dates" section, below.

[16] This result is not affected by the fact that the property was rented for a lesser amount than would be charged in a lease between unrelated parties. However, the rent from such a lease could not be used under the formula valuation method since that method requires an arm's-length rental based on a fair market value rate of return on the land.

(which condition lasted until the date of the decedent's death), or (3) the date on which the decedent began receiving social security retirement benefits (which status continued until the date of the decedent's death).

Under the Act, an individual is considered to be disabled if the individual is mentally or physically unable to materially participate in the operation of the farm or other business. However, while failure by an individual to materially participate may be evidence of disability, no presumption of disability arises from such a failure to materially participate. The Congress anticipates that the Treasury Department will develop regulations providing rules for determining when an individual is disabled for purposes of this provision of the Act.

Deemed material participation for certain surviving spouses.—The Congress recognized that some surviving spouses may be unable to materially participate in farm operations following the death of the first spouse to die. Therefore, the Act provides an alternative to the material participation requirement for qualification of real property for current use valuation in the estates of surviving spouses who receive the property from a decedent spouse in whose estate it was eligible to be valued based on its current use. The Act provides that the spouse will be treated as having materially participated during periods when the spouse (but not a family member) engaged in active management of the farm or other business operation. The Act contains a special rule for tacking material participation by a decedent spouse in the case of a surviving spouse who dies within eight years of death of the first spouse to die.

This rule is illustrated by the following example. Assume that B dies two years after A (B's spouse) in whose estate Whiteacre was eligible for current use valuation. B engaged in the active management of Whiteacre during the two years following A's death. A was retired for the five years immediately before A's death, but had materially participated in Whiteacre's operation for eight years before his retirement. The six most recent of the eight years before A's retirement will be considered with B's two years of active management for purposes of satisfying the five years of an eight-year period pre-death material participation requirement for B's estate.

For this purpose, active management means the making of business decisions other than the daily operating decisions of a farm or other trade or business. The determination of whether active management occurs is factual, and the requirement can be met even though no self-employment tax is payable under section 1401 by the spouse with respect to income derived from the farm or other trade or business operation. Among the farming activities, various combinations of which constitute active management, are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended and making a substantial number of the management decisions of the business operation. Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business oper-

ations, and what capital expenditures the trade or business should make.

Qualification of certain property acquired in nontaxable events.—The Act permits tacking of the ownership, qualified use, and material participation requirements in the case of replacement property acquired pursuant to like-kind exchanges under section 1031 and involuntary conversions under section 1033. This tacking is available only for that portion of the replacement property or exchange property which does not exceed the value of the property disposed of in the exchange or conversion, and is permitted only when the replacement property or exchange property is used in the same qualified use as the property which was disposed of. The Act contains special rules for determining the portion of the replacement property or exchange property that qualifies in the case of an exchange in which the two properties are not equal in value.

Change to election requirements

The Congress believed that qualified heirs should not be deprived of the benefits of current use valuation solely because the decedent's estate tax return is filed after the date on which it is due. Accordingly, under the Act, elections to specially value property must be made on the decedent's estate tax return rather than by the due date of the return as under prior law. Therefore, beginning with estates of decedents dying after December 31, 1981, the election is permitted to be made on a late return, if that return is the first estate tax return filed by the estate. As under prior law, the election is irrevocable once made.

Changes in valuation requirements

Increased reduction in fair market value

The Act increases the maximum amount by which the fair market value of qualified property may be reduced as a result of current use valuation to take into account increases in real property values since 1976. The previous $500,000 limit is increased to $600,000 for estates of decedents dying in 1981, $700,000 in 1982, and $750,000 in 1983 and thereafter.

Formula valuation method

The Act permits substitution of net share rentals for cash rentals in the formula valuation method for farm real property if the executor cannot identify actual tracts of comparable farm real property in the same locality as the decedent's farm property that are rented for cash. This change generally insures availability of the formula method to farms in areas where share, rather than cash, rentals are traditionally used. The Act does not change the requirement that the executor must substantiate the comparable land and rental information to be used in valuing the decedent's property.

The amount of a net share rental is equal to the gross value of the produce received by the lessor of the comparable land during a calendar year minus the cash operating expenses (other than real property taxes) of growing the produce which are paid by the

lessor.[17] The term "produce" means a crop or other product (including by-products), such as cattle, production of which is the business purpose of the farming operation. Where produce is disposed of in an arm's-length transaction within a period no longer than the period established by the U.S. Department of Agriculture for its price support program immediately following the date or dates on which the produce is received (or constructively received) by the lessor, it is intended that the gross amount received in the disposition will be the gross value of the produce.[18]

If there is no arm's-length disposition within the established period, the value of the produce shall be determined as of the date or dates on which the produce is received (or constructively received) and shall equal the weighted average price for which produce of that type sold on the closest national or regional commodities market to the farm property on that date or dates.

As under prior law, if there is no comparable land from which a cash or share rental can be determined, the real property subject to the election is to be valued using the multiple factor valuation method.

Special rule for standing timber

The Act provides that the executor may elect to treat standing timber as an interest in real property and specially value the timber as part of the qualified real property on which the timber is located, rather than valuing it based upon its fair market value like other growing crops.[19] Standing timber is to be specially valued by reference to similar timber located on comparable land where both the land and timber are rented for timber growing purposes under a cash or share rental lease.[20] If no comparable standing timber and land are so rented in the locality of the decedent's property, the timber and land are to be specially valued using the multiple factor method.

Under the current use valuation provision, as amended by the Act, if specially valued standing timber is severed or otherwise disposed of by the qualified heir within ten years after the decedent's death (or before the death of the qualified heir, if earlier), a recapture tax is imposed (sec. 2032A(c)). This recapture tax is determined by treating the timber as an interest in the real property on which the timber stands or stood.

For purposes of the rules governing imposition of the recapture tax in the event of a partial disposition of qualified property (sec. 2032A(c)(2)(D)), the pro rata portion of the value of the property disposed of is determined by comparing the number of acres of land on which timber is severed or otherwise disposed of to the total

[17] The Congress understood that, in some areas, farm real property is traditionally rented on a share basis, but the lessee disposes of (or retains for disposition) the entire crop, etc., and the lessor receives only the proceeds (or an agreed set value) of his portion of the farm's production. In such cases, the value of the share rental is to be determined according to the rules for valuing farm produce when the lessor actually receives a share of the farm's crop or other production.

[18] The Congress understood that the present period established by the Department of Agriculture price support program is five months.

[19] Specially valued standing timber is subject to the special lien securing payment of the recapture tax (sec. 6324B) to the same extent as the land on which the timber stands.

[20] Leases for purposes other than growing timber to which the comparable land is subject cannot be used to determine the value of qualified timber property in its current use under the formula valuation method (sec. 2032A(e)(7)(A)).

number of acres of specially valued real property owned by the qualified heir. The Act provides a special rule for a severance or other disposition of a portion of the standing timber on an identifiable portion of the specially valued land. In such a case, the amount realized (or the fair market value on the date of severance or disposition in any case other than a sale or exchange at arm's length) on each such severance or disposition is payable as additional tax until the pro rata portion of recapture tax attributable to the identifiable portion of the land on or from which timber was severed or disposed of (including all timber thereon) has been paid.

For purposes of these rules on partial dispositions, an identifiable portion of land is defined as an acre or other area of land by which the taxpayer normally maintains his business records. It is intended that the Treasury Department will develop regulations defining when a complete severance or other disposition of timber on an identifiable portion of land occurs.

Changes to post-death recapture rules

Reduction in recapture period

The Act reduces the prior 15-year recapture period to ten years; the five-year phase-out period of prior law is repealed. Thus, under the Act, the amount subject to recapture is not reduced until expiration of the ten-year recapture period. The recapture period begins on the date of the decedent's death, and extends for 10 years (15 years in the case of estates of decedents dying before January 1, 1982) from that date, or the date on which the qualified heir commences the qualified use if that use begins within two years after the decedent's death. This period is extended further in the case of an involuntary conversion of specially valued property which is followed by the acquisition of qualified replacement property. Such an extension is equal to the excess over two years of the period between the date of the involuntary conversion and the date on which the qualified heir commences use of the replacement property in the qualified use.

Qualified use requirement

The Act creates a special two-year grace period immediately following the date of the decedent's death during which failure by the qualified heir to commence use of the property in the qualified use will not result in imposition of a recapture tax. As described above in the discussion of the reduction in recapture period, the ten-year recapture period (15 years for estates of decedents dying before January 1, 1982) is extended by a period equal to any part of the two-year grace period which expires before the qualified heir commences using the property in the qualified use. Failure by the heir personally to use the property in the qualified use based upon which it was valued in the decedent's estate at any time after the two-year grace period and before the end of the recapture period will result in imposition of the recapture tax.[21] Therefore, if at any time after the two-year grace period, the qualified heir enters into a net cash lease or any other lease for less than a fair market

[21] This amendment applies retroactively to certain estates of decedents dying after December 31, 1976. A complete explanation of this retroactive effect is included in the "Effective Dates" section, below.

rental (including an arrangement that permits another person to use the property without paying any rent), a cessation of qualified use occurs.

Deemed material participation for eligible qualified heirs

In the case of an eligible qualified heir, the Act provides an alternative to the requirement that there be material participation by a qualified heir (or a member of the heir's family)[22] during the recapture period.[23] The material participation requirement for a period is considered to be met during periods when the eligible qualified heir (but not a member of the heir's family) engages in active management of the farm or other business operation. In the case of an eligible heir who has not attained the age of 21 or who is disabled, the active management may be that of a fiduciary (e.g., a guardian or trustee, but not an agent). The alternative of using active management applies only during those periods during which the heir is an eligible heir.

Eligible qualified heirs include the spouse of the decedent, a qualified heir who has not attained the age of 21, a qualified heir who is a full-time student (within the meaning of sec. 151(e)(4)), and a qualified heir who is disabled (within the meaning of sec. 2032A(b)(4)(B), as added by the Act). Active management means the making of business decisions other than the daily operating decisions of the trade or business.[24]

Certain like-kind exchanges nontaxable

The Act provides that an exchange pursuant to section 1031 of qualified real property solely for qualified replacement property to be used for the same qualified use as the original real property does not trigger a recapture of the benefits from current use valuation.[25]

Repeal of election requirement for special involuntary conversion rules

The Act repeals the requirement that a qualified heir make an election to secure the benefits of the special nonrecognition rules applicable to the recapture tax for involuntary conversions.[26]

Increase in basis of property on which a recapture tax is paid

The Act permits a qualified heir to make an irrevocable election to have the income tax basis of qualified real property increased to the fair market value of the property as of the date of the decedent's death (or the alternate valuation date under section 2032, if

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[22] The required material participation must be that of the decedent or a member of the decedent's family during periods when the decedent owned the property.

[23] Section 2032A(c)(7)(B) generally requires that material participation occur during periods aggregating five years or more of every eight-year period ending after the date of the decedent's death and before ten years after that date (15 years in the case of estates of decedents dying before January 1, 1982).

[24] The meaning of active management is more fully explained in the discussion of the changes to the material participation requirement for qualification of property for current use valuation in the estates of certain surviving spouses.

[25] The lien securing payment of the recapture tax (sec. 6324B) will have to be transferred to the qualified replacement property at the time the original qualified property is discharged from that lien for this nonrecognition treatment to apply.

[26] The lien securing payment of the recapture tax (sec. 6324B) will have to be transferred to the qualified replacement property at the time the original qualified property is discharged from the lien for this nonrecognition treatment to apply.

the estate elected that provision) where the recapture tax is paid. In the case of a recapture tax imposed on a disposition of replacement property previously acquired in a nontaxable event under sections 2032A (h) or (i) (relating to certain involuntary conversions and like-kind exchanges), the adjustment to basis is made by reference to the fair market value of the original specially valued property.

The basis determined under this rule is the basis the qualified heir would have received had current use valuation not been elected for the decedent's estate. This increase in basis is effective as of the date immediately before the disposition or cessation of qualified use; therefore, no retroactive changes in depreciation, or other deductions or credits, would be made to reflect the increased basis. However, in the case of a recapture tax arising from a disposition of the property, the increased basis is used in determining the gain or loss from the disposition.

The Act provides that, in the case of a partial disposition, the income tax basis of the heir's entire interest will be increased by the same proportionate amount of the difference between the fair market value and the current use value of the entire interest as the recapture tax actually imposed bears to the total potential recapture tax on the heir's entire interest.

If the heir elects this basis adjustment, the heir must pay interest on the amount of the recapture tax from the date which is nine months after the decedent's death until the due date of the recapture tax. The interest is computed at the rate (or rates) charged on deficiencies of tax for the period involved. If the heir does not make the election and pay the interest, no adjustment is made to the basis of the property.

Miscellaneous technical changes

Property transferred to discretionary trusts

The Act creates an exception to the general requirement that a qualified heir receive a present interest (under sec. 2503) in all property to be specially valued or to be used to determine whether the estate otherwise qualifies for current use valuation.[27] The exception provides that property meeting the other requirements for current use valuation can be specially valued and used to determine whether the threshold percentage requirements for qualification (sec. 2032A(b)(1)) are satisfied if the property passes to a discretionary trust in which no beneficiary has a present interest (under sec. 2503) because of the discretion in the trustee to determine the amount to be received by any individual beneficiary so long as all potential beneficiaries of the trust are qualified heirs of the decedent (under sec. 2032A(e)(1)).[28]

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[27] This amendment applies retroactively to certain estates of decedents dying after December 31, 1976. A complete explanation of this retroactive effect is included in the "Effective Dates" section, below.

[28] The rules of prior law governing property owned indirectly through ownership of interests in corporations, partnerships, and trusts (sec. 2032A(g) and Reg. § 20.2032A-3 (b) and (f)) are otherwise unchanged by this amendment. Therefore, property held in a qualifying discretionary trust will be treated under the current use valuation provision as if the property were owned by a corporation with the beneficial owners of the trust being treated as shareholders of the corporation (the treatment given trust interests with fixed rights under prior law). The effect of this rule is to treat a discretionary interest in a qualifying trust as if the interest were voting

Definition of family member

The Act changes the definition of family member. The new definition includes only an individual's spouse, parents, brothers, sisters, children, stepchildren, and spouses and lineal descendants of those individuals.

When property is acquired from a decedent

Under section 2032A, only that property which is acquired from a decedent is eligible for current use valuation. The Act expands the circumstances in which property is considered to be so acquired to include property that is purchased from a decedent's estate by a qualified heir as well as property that is received by bequest, devise, inheritance, or in satisfaction of a right to pecuniary bequest.[29] This change reverses prior law in cases where the decedent gives a qualified heir an option to purchase property otherwise qualified for current use valuation[30] as well as in cases where the executor sells the property to an heir in the absence of such a direction in the will.

If purchased property is specially valued, the qualified heir who purchases the property is limited to the current use value of the property as his income tax basis even if the purchase price is in excess of the use value.[31]

The Act provides that the estate does not recognize gain on the sale for income tax purposes, except to the extent that the sales price exceeds the fair market value of the property on the date of the decedent's death.

The Congress was aware that many decedents establish the purchase price for family farm and closely held business property in their wills. In cases where this price is established in the decedent's will by reference to estate tax value, the price will normally be construed under applicable local law as meaning the fair market value unless the will expressly refers to the current use valuation provision. In such cases, the qualified heir's purchase price frequently will be in excess of his income tax basis. The Congress intended that this excess not be treated as a taxable gift by the purchasing heir to the estate or the other heirs. In cases where the purchase price is construed under applicable local law as the current use value of the property, the other qualified heirs also are not to be treated as making a taxable gift to the purchasing heir by virtue of giving any required consent to the current use valuation election (and thereby to the lower purchase price).

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common stock in a corporation (e.g., a type of corporate ownership which qualifies under sec. 2032A(g)).

Under these rules, the trust as an entity must satisfy the post-death qualified use test (under sec. 2032A(c)(1)(B)), and the trust must enter into an arrangement with the qualified heir owning the beneficial interest in the trust pursuant to which that heir, or a member of the heir's family, materially participates in the operation of the trade or business (as required under sec. 2032A(c)(7)(B)).

[29] This amendment applies retroactively to certain estates of decedents dying after December 31, 1976. A complete explanation of this retroactive effect is included in the "Effective Dates" section, below.

[30] Under prior law, the property generally was not considered to have been acquired from the decedent whether or not the option was eventually exercised.

[31] Normally, the income tax basis of purchased property is its cost (sec. 1012).

Effective Dates

The changes to the current use valuation rules apply generally to estates of decedents dying after December 31, 1981.

The increase in the limitation on the amount by which the fair market value of specially valued property may be reduced applies to estates of decedents dying after December 31, 1980.

The changes to the recapture period rules on involuntary conversions (under sec. 1033) and like-kind exchanges (under sec. 1031) apply to such exchanges occurring after December 31, 1981, even if the decedent in whose estate the property was specially valued died before that date.

The Congress believed that four of the changes included in the Act are primarily technical and should be applied retroactively in certain cases as well as to all estates for which estate tax returns are not due to be filed until after the date of enactment of the Act (August 13, 1981). The Congress intended that the following changes be applied retroactively:

(1) The provision that the qualified use requirement may be satisfied during pre-death periods where the trade or business use is that of the decedent or a member of the decedent's family;

(2) The provision that property passing to discretionary trusts, all potential beneficiaries of which are qualified heirs, is considered to have satisfied the requirement that specially valued property be acquired from the decedent;

(3) The provision that property purchased from a decedent's estate by a qualified heir is considered to have satisfied the requirement that specially valued property be acquired from the decedent; and

(4) The provision permitting a qualified heir a two-year grace period immediately after the decedent's death during which failure to use the specially valued property in the qualified use will not result in imposition of a recapture tax.

These four changes apply to all estates for which estate tax returns are due to be filed after the date of enactment of the Act (August 13, 1981), and also apply retroactively to:

(a) All estates of decedents dying after December 31, 1976, for which the estate tax return was due and timely filed on or before July 28, 1980, the date on which the final Treasury regulations under section 2032A were adopted, provided that the estate timely elected current use valuation on the decedent's estate tax return (even if the election was subsequently revoked pursuant to Treas. Reg. § 20.2032A-8(d)); and

(b) All estates of decedents for which an estate tax return was due and timely filed after July 28, 1980, and on or before August 13, 1981, whether or not the estate originally elected the current use valuation provision.

Estates for which estate tax returns were due and timely filed before enactment of the Act which are eligible to reinstate (or make) elections because of these retroactive changes must do so on or before the date which is six months after the date of enactment (i.e., February 16, 1982). The elections are to be reinstated by making a claim for refund accompanied by the documentation presently prescribed in Treasury regulations for making a current use valuation election.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $18 million in 1982, $280 million in 1983, $295 million in 1984, $326 million in 1985, and $319 million in 1986.

2. Extensions of time for payment of estate tax attributable to interests in closely held businesses (sec. 422 of the Act and secs. 303, 6166, and 6166A of the Code)*

Prior Law

Under prior law, two overlapping provisions permitted an estate to pay the estate taxes attributable to interests in closely held businesses in installments.

If the value of an interest in a closely held business [1] exceeded 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest could be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applied to the tax on the first $1 million of value of the interest in a closely held business that was payable in installments under section 6166 (sec. 6601(j)). If the value of the interest in a closely held business exceeded either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest could be paid in up to ten annual installments (sec. 6166A).

Under both provisions, the payment of any unpaid tax was accelerated if there was a failure to pay timely any installment, or if there was a disposition of a specified fraction of the value of the decedent's interest in the business or a withdrawal equal to a specified fraction of the business. This fraction was one-third in the case of section 6166 and one-half in the case of section 6166A. However, sections 6166 and 6166A also provided several exceptions to these acceleration rules. One such exception provides that redemptions of stock under section 303 (relating to the income tax treatment of certain redemptions for the payment of estate taxes and certain other expenses) will not be considered a withdrawal for purposes of the acceleration rules if an amount equal to the redemption proceeds is used to pay Federal estate taxes on or before the due date of the first installment which becomes due after the date of distribution.

Under section 303, if more than 50 percent of the gross estate (reduced by allowable expenses, losses, and indebtedness) consisted of stock in a single corporation, redemption of all or a portion of that stock to pay estate taxes, funeral expenses, and administration expenses was treated as a sale or exchange subject to capital gains treatment instead of a dividend which would be taxed as ordinary income.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 406; S. Rep. No. 97-144 (July 6, 1981), pp. 140-141; Senate floor amendment, 127 Cong. Rec. S8598-99 (daily ed. July 28, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 422; H. Rep. No. 97-201 (July 24, 1981), pp. 180-183; H.R. 4242, as passed by the House (July 29, 1981), sec. 422; and H. Rep. No. 97-215 (August 1, 1981), p. 255 (Joint Explanatory Statement of the Committee of Conference).

[1] Under certain circumstances, the stock of two or more corporations can be combined in determining whether the estate qualifies for sections 6166, 6166A, and 303.

Reasons for Change

The Congress believed that simplification and clarity are needed in the provisions permitting installment payment of estate taxes attributable to closely held businesses. Under prior law, although both sections 6166 and 6166A permitted installment payment for estates a substantial portion of which consisted of an interest in a closely held business, there were unnecessary differences between the two sections. The definition of a closely held business, the percentage of estate assets required to be represented by such an interest, the length and conditions of the installment payment period, the appropriate interest rate, and the conditions for acceleration varied between the sections.

Because the existence of two installment provisions with differing requirements created confusion, the Congress concluded that these provisions should be simplified by merging the two sections to provide a single set of rules to govern the installment payment of estate taxes attributable to an interest in a closely held business.

In addition, the Congress believed that the provisions of prior law section 6166, which restricted eligibility for installment payments to an estate in which the closely held business interest comprised at least 65 percent of the adjusted gross estate, have proven unduly restrictive. The Congress concluded that the minimum percentage of the adjusted gross estate required to be invested in a closely held business should be reduced to 35 percent.

The Congress also believed that certain changes are needed to the rules requiring acceleration of payment of the remaining unpaid tax. First, the Congress believed that payment of the remaining unpaid tax should not be accelerated because of the late payment of the interest or principal if the entire installment of principal and all accrued interest is paid within six months of the original due date. Second, the Congress believed that the requirement that the remaining unpaid tax be accelerated upon the disposition of the decedent's interest in a closely held business or on the withdrawal of assets from such business should be changed to permit cumulative dispositions or withdrawals of up to 50 percent of the decedent's interest. Third, in order to help preserve ownership of closely held businesses within a family, the Congress believed that the transfer of a qualified interest in a closely held business upon the death of decedent's heir should not cause acceleration of the payment of the remaining unpaid tax where the subsequent transferee is a family member of the heir.

The redemption of stock in certain closely held businesses to pay estate taxes, funeral expenses, and administration expenses is treated as a sale or exchange (eligible for capital gains treatment) instead of a dividend (treated as ordinary income) (sec. 303). However, under prior law, the definition of an interest in a closely held business and the rules for aggregating multiple interests in closely held businesses provided by section 303 were different from the definitions contained in either of the provisions which permitted installment payment of the estate taxes attributable to an interest in a closely held business. The Congress believed that a single definition of a closely held business and a single set of aggregation rules should apply to govern redemptions of closely held business stock to pay estate taxes, funeral expenses, and administration

expenses and the installment payment of estate taxes attributable to an interest in a closely held business.

Explanation of Provision

The Act repeals section 6166A and expands the provisions of section 6166 to all estates in which the value of an interest in a closely held business exceeds 35 percent of the value of the adjusted gross estate. If the value of the interest in a closely held business exceeds 35 percent of the value of the adjusted gross estate, the estate taxes attributable to the value of that interest may be paid in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first $1 million of value of an interest in a closely held business (sec. 6601(j)).

The Act makes several changes to the acceleration rules provided by section 6166. First, the Act allows cumulative dispositions and withdrawals from the business of amounts up to 50 percent of the decedent's interest before requiring acceleration of the payment of the remaining unpaid tax. Thus, if an estate withdraws amounts equal to 30 percent of the decedent's interest in a closely held business for which installment payment is elected and separately disposes of 20 percent or more of the decedent's interest in such business, payment of the remaining unpaid tax will be accelerated.

Second, the Act provides that acceleration will be triggered by a delinquent payment of interest as well as a delinquent payment of tax. Therefore, an estate may not avoid payment of interest during the initial four-year period without accelerating payment of the remaining unpaid tax. However, if the full amount of any delinquent payment (principal and all accrued interest) is paid within six months of its original due date, payment of the remaining unpaid tax will not be accelerated. Rather, with respect to any interest due with such payment, the estate is not eligible for the special four-percent interest rate (under sec. 6601(j)) and a penalty is imposed, equal to five percent per month, based on the amount of the payment, computed after the disallowance of the special four-percent interest rate. This penalty is in addition to any penalties or interest charges otherwise imposed by the Code on delinquent payments.

Third, the Act provides that the transfer of an interest in a closely held business from an heir (or subsequent transferee) at his death to a family member of the heir (or subsequent transferee) will not be considered a disposition of that interest. For this purpose, the Act adopts the definition of a family member contained in section 267(c)(4).

The Act also makes conforming changes to section 303, which provides special treatment for the redemption of stock in a closely held business to pay estate taxes, funeral expenses, and administration expenses. Under the Act, redemptions will be treated as a sale or exchange eligible for capital gains treatment if the decedent's interest in a closely held corporation comprises at least 35 percent of the decedent's adjusted gross estate. In addition, the section 303 rules regarding the aggregation of interests in two or more corporations are conformed to those in section 6166.

Effective Date

In general, these changes apply to the estates of decedents dying after December 31, 1981. However, the provision regarding acceleration of payment upon the death of an heir applies with respect to transfers made after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $20 million in 1983, $16 million in 1984, $15 million in 1985, and $12 million in 1986.

3. Charitable gifts of certain tangible personal property (sec. 423 of the Act and secs. 2055 and 2522 of the Code)*

Prior Law

Both gift tax and estate tax deductions generally are allowed for certain amounts transferred for charitable purposes in determining both the amount of taxable gifts and the amount of taxable estate. If the charitable transfer is an interest that is less than the entire interest in property (e.g., a remainder interest), the gift must take certain specified forms in order to be deductible. Generally, no deduction is allowed for a remainder interest unless the remainder interest is in a charitable remainder annuity trust, charitable remainder unitrust, a pooled income fund, a farm, or a personal residence. In all other cases, the charitable interest must be either a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the property. In addition, deductions are allowed for charitable gifts of certain undivided interests, including scenic easements.

Under prior estate and gift tax law, an original work of art and a copyright interest relating to that work of art were considered two interests in the same property (c.f., Treas. Regs. § 1.170A-7(b)(1)). Thus, no charitable deduction was allowed if an individual gave the original of an art work to charity but retained the copyright interest attributable to that art work.

Reasons for Change

The restrictions on deductibility of split interest transfers to charity were added by the Tax Reform Act of 1969 to insure that there was a reasonable correlation between the amount of the charitable deduction and the value of the property received by charity. The rules provided by the Congress to accomplish this result disallowed the charitable deduction if interests in the same property were transferred for both charitable and noncharitable purposes unless the charitable interest was in certain specified forms.

However, recent changes in copyright law treat the tangible object (i.e., the original art work) and the intangible copyright as separate items of property.[1] These two items of property typically are not transferred together. Moreover, the use or exploitation of the art work or copyright generally does not affect the value of the other property. As a result, it will be possible to determine the value of the tangible object (i.e. the original art work) apart from its related copyright interest by reference to values of similar

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 423; H. Rep. No. 97-201 (July 24, 1981), pp. 184-185; H.R. 4242, as passed by the House (July 29, 1981), sec. 423; and H. Rep. No. 97-215 (August 1, 1981), p. 256 (Joint Explanatory Statement of the Committee of Conference).

[1] See 17 U.S.C. § 102.

objects which are sold without their copyright interest. Accordingly, the value of the art work which is used to determine the amount of the charitable deduction should provide a high degree of correlation with the value of property received by charity.

The Congress concluded, therefore, that the disallowance rule for transfers of split interests in property should not apply to a work of art and the related copyright in cases where the work of art but not the copyright is transferred to charity and where there are restrictions to insure that the public will benefit from the transfer. However, the Congress believed that this rule should apply only for estate and gift tax purposes and not for income tax purposes. Thus, the provisions of the Act allow gifts and bequests of works of art for the benefit of the general public without imposition of tax, but do not provide the unnecessary tax incentive that could occur if the provision were extended to the income tax.

Explanation of Provision

Under the Act, if a donor or decedent makes a qualified contribution of a copyrightable work of art to a qualified organization, the work of art and its copyright are treated as separate properties for purposes of the estate and gift tax charitable deductions. Thus, a charitable deduction generally is allowable for the transfer to charity of a work of art, whether or not the copyright itself is simultaneously transferred to the charitable organization.

A qualified organization is a public charity (i.e., an organization described in sec. 501(c)(3) which is not a private foundation under sec. 509) or a private operating foundation (under sec. 4942(j)(3)). The Act provides that a qualified contribution is any transfer to a qualified charitable organization provided the use of the property by the organization is related to its charitable purpose or function.

Effective Date

The provision applies with respect to gifts made, and estates of decedents dying, after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

4. Transfers made within three years of death (sec. 424 of the Act and sec. 2035 of the Code)*

Prior Law

Under prior law, transfers made by a decedent within three years of death were included in the decedent's gross estate without regard to whether the gifts were made in contemplation of death (sec. 2035). A gift included in the decedent's gross estate was valued at the time of the decedent's death (or alternate valuation date, if elected). However, any gift tax paid was allowed as a credit against the decedent's estate tax. In general, the net effect of these two provisions was to include in the decedent's gross estate the property's appreciation in value from the date of the gift until the date of death.

An exception to these rules applied with respect to transfers of property (other than transfers with respect to a life insurance policy) if no gift tax return was required to be filed with respect to the gift. Thus, a gift for which no gift tax return was required was generally not included in the decedent's gross estate, while a gift subject to the filing requirements was included at its appreciated value, without reduction for the amount of the gift tax annual exclusion.

Generally, if an interest in property was included in a decedent's gross estate under this provision, the donee's basis in such interest was its fair market value on the date of the decedent's death (or alternate valuation date, if elected), reduced by amounts claimed by the donee as a deduction in computing taxable income prior to the decedent's death (sec. 1014).

Reasons for Change

Under the law prior to the Tax Reform Act of 1976, gifts made in contemplation of death (other than gifts made more than three years before the decedent's death) were included in a decedent's gross estate to prevent deathbed transfers designed to avoid estate taxes. However, the prior law presumption that gifts made within three years of death were made in contemplation of death caused considerable litigation concerning the motives of decedents in making gifts. As a result, Congress, in 1976, eliminated the problem by requiring the inclusion of all such gifts in a decedent's estate without regard to the motives of the decedent.

Under the unified transfer tax system adopted in the Tax Reform Act of 1976, the inclusion in the gross estate of gifts made within three years of death generally had the effect of including

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 405; S. Rep. No. 97-144 (July 6, 1981), pp. 138-139; H.R. 4242, as reported by the House Ways and Means Committee, sec. 424; H. Rep. No. 97-201 (July 24, 1981), pp. 186-187; H.R. 4242, as passed by the House (July 29, 1981), sec. 424; and H. Rep. No. 97-215 (August 1, 1981), p. 255 (Joint Explanatory Statement of the Committee of Conference).

only the property's post-gift appreciation in the gross estate (because the gift tax paid with respect to the transfer is allowed as a credit against the decedent's estate tax). The Congress concluded that inclusion of such appreciation generally is unnecessary, except for gifts of certain property included in the gross estate pursuant to certain of the so-called transfer sections (secs. 2036, 2037, 2038, 2041, and 2042). However, the Congress believed that gifts made within three years of death should be included in a decedent's gross estate to determine the estate's eligibility for favorable redemption, valuation, and installment payment provisions (under secs. 303, 2032A, and 6166) to preclude deathbed transfers designed to qualify that estate for such favorable treatment.

Explanation of Provision

In general, the Act provides that section 2035(a) is not applicable to the estates of decedents dying after December 31, 1981. Thus, gifts made within three years of death will not be included in the decedent's gross estate, and the post-gift appreciation will not be subject to transfer taxes. Accordingly, such property will not be considered to pass from the decedent and the step-up basis rules of section 1014 will not apply.

The Act contains exceptions which continue the application of section 2035(a) to interests in property included in the value of the gross estate pursuant to sections 2036, 2037, 2038, 2041, or 2042 (or those interests which would have been included under any of such sections if the interests described in those sections which were created by the decedent had been retained by the decedent until his death). Thus, such property will still be included in the decedent's gross estate at its estate tax value (without reduction for the amount of the annual gift tax exclusion). As under prior law, property included pursuant to any of those sections will be included whether or not a gift tax return was required with respect to the transfer. For example, if one year prior to death, a decedent transferred any incident of ownership in a life insurance policy to a third party, the entire amount of the proceeds will be included in the decedent's gross estate pursuant to sections 2035 and 2042.

In addition, all transfers within three years of death (other than gifts eligible for the annual gift tax exclusion) are included for purposes of determining the estate's eligibility for special redemption, valuation, and installment payment purposes (under secs. 303, 2032A, and 6166) and for purposes of determining which property is subject to the estate tax liens (under subchapter C of Chapter 64). For these purposes, the amount to be included is the fair market value at date of death (or alternate valuation date if elected).

Section 2035(c), requiring the inclusion of all gift taxes paid by the decedent or the decedent's estate on any gift made by the decedent or the decedent's spouse after December 31, 1976, and within three years of death, will continue to apply to all estates regardless of whether the gift with respect to which the gift tax was paid is includible in the gross estate under section 2035.

Effective Date

The provision applies to the estates of decedents dying after December 31, 1981. Thus, the provision applies to determine the inclusion of gifts made prior to December 31, 1981, in the gross estate of a decedent dying after that date.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1982, $58 million in 1983, $50 million in 1984, $42 million in 1985, and $38 million in 1986.

5. Basis of property acquired from a decedent (sec. 425 of the Act and sec. 1014 of the Code)*

Prior Law

Generally, the basis of property acquired from or passing from a decedent is its fair market value at the date of death (or the alternate valuation date if elected) (sec. 1014).[1] Thus, if the fair market value of the property appreciates after the decedent acquires it, the resulting gain is never subject to income tax. On the other hand, if the property depreciates in value after the decedent acquires it, the loss is not deductible for income tax purposes. The basis of property acquired from or passing from the decedent is often referred to as a "stepped-up" basis. (Although basis may have been adjusted upward or downward at death, upward adjustments are more common, partly because property tends to appreciate over time, and partly because individuals may dispose of their loss property prior to death, but tend to hold property which has appreciated in order that the beneficiaries receive the "step-up.") This "step-up" is applicable regardless of the date on which the decedent acquired the property or the manner of acquisition.

Reasons for Change

Because an heir receives property from a decedent with a stepped-up basis, an heir can transfer appreciated property to a decedent immediately prior to death in the hope of receiving the property back at the decedent's death with a higher basis. The donor-heir would pay gift taxes on the fair market value of the gift (unless it qualified for the marital deduction or the amount of gift is less than the donor's annual exclusion or unified credit), but would pay no income tax on the appreciation. Then, where the donee-decedent bequeathed the property back to the donor-heir, the donor-heir would receive the property with a stepped-up basis equal to its fair market value. The stepped-up basis has the effect of permanently exempting the appreciation from income tax.

Because the Act provides an unlimited marital deduction and substantially increases the unified credit, the Congress believed that there would be an even greater incentive to plan such deathbed transfers of appreciated property to a donee-decedent. Because the Congress believed that allowing a stepped-up basis in this situation would provide unintended and inappropriate tax benefits, the Act provides that the stepped-up basis rules do not apply to appreciated property acquired by the decedent through gift within

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 425; H. Rep. No. 97-201 (July 24, 1981), pp. 188-189; H.R. 4242, as passed by the House (July 29, 1981), sec. 425; and H. Rep. No. 97-215 (August 1, 1981), p. 256 (Joint Explanatory Statement of the Committee of Conference).

[1] For purposes of this discussion, a reference to the fair market value at the date of the decedent's death will include reference to the value of the property on the alternate valuation date.

one year of death where such property passes from the decedent to the original donor or the donor's spouse.

Explanation of Provision

For decedents dying after December 31, 1981, the Act provides that the stepped-up basis rules for inherited property contained in section 1014 do not apply with respect to appreciated property acquired by the decedent through gift (including the gift element of a bargain sale) after August 13, 1981, and within one year of death, if such property passes, directly or indirectly, from the donee-decedent to the original donor or the donor's spouse.

The denial of a stepped-up basis applies where the donor receives the benefit of the appreciated property regardless of whether the bequest by the decedent to the donor is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest. However, in the case of a pecuniary bequest, the donor is treated as receiving the benefit of the appreciated property only to the extent that the inclusion of the appreciated property in the estate of the decedent affects the amount that the donor receives under the pecuniary bequest.

For example, assume that A gives appreciated property with a basis of $10 and a fair market value of $100 to D within one year of D's death, that D's date of death basis was $20, and that the date of death fair market value of the property was $200. If A is entitled to the property by reason of D's death, A's basis in the property will be $20. If A subsequently sells the property for its fair market value of $200, A will recognize gain of $180. If, instead, the executor sells of the property, distributing the proceeds to A, similar rules will apply and the estate will recognize a gain of $180.

This rule applies only to the extent that the donor-heir or his spouse is entitled to receive the value of the appreciated property. If the heir or his spouse is only entitled to a portion of the property (e.g., because the property must be used to satisfy debts or administration expenses), the rule applies on a pro-rata basis. Thus, in the above example, if the decedent's estate consisted only of the appreciated property and total estate liabilities were $50, the heir would only be entitled to three-fourths of the appreciated property. Accordingly, the portion of the property to which the donor-heir was not entitled (one-fourth in the example) will receive a stepped-up basis. In such a case, the basis of the appreciated property in the hands of the executor or the heir will be $65 (i.e., one-fourth of $200 (or $50) plus three-fourths of $20 (or $15)).

Effective Date

The provision applies with respect to property acquired after the date of enactment (August 13, 1981) by decedents dying after December 31, 1981.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

6. Disclaimers (sec. 426 of the Act and sec. 2518 of the Code)*

Prior Law

A disclaimer is effective for Federal estate and gift tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions (sec. 2518). First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[1] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[2] For purposes of this requirement, the person making the disclaimer cannot have the authority to direct the redistribution or transfer of the property to any other person.

Reasons for Change

Prior to the enactment of section 2518, a disclaimer, to be effective for Federal estate and gift tax purposes, had to be valid under local law, unequivocal, and made within a reasonable time after knowledge of the transfer and before acceptance of any benefits. Thus, the Federal tax consequences of an attempted disclaimer largely depended on its treatment under local law. When the Congress enacted section 2518 in the Tax Reform Act of 1976, it intended to create a uniform Federal standard so that a disclaimer could be effective for Federal estate and gift tax purposes whether or not valid under local law.

Section 2518 required, among other conditions, that the disclaimer be effective under local law to pass title without direction on the part of the person making the disclaimer and that the property

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 407; S. Rep. No. 97-144 (July 6, 1981), p. 142; H.R. 4242, as reported by the House Ways and Means Committee, sec. 426; H. Rep. No. 97-201 (July 24, 1981), pp. 190-191; H.R. 4242, as passed by the House (July 29, 1981), sec. 426; and H. Rep. No. 97-215 (August 1, 1981), pp. 255-256 (Joint Explanatory Statement of the Committee of Conference).

[1] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[2] In general, the disclaimed interest must pass to persons other than the person making the disclaimer. However, under the limited marital deduction of prior law, it was common for a decedent to provide two trusts—one which qualified for the marital deduction (called "the marital deduction trust") and one for the benefit of the surviving spouse and his descendents (called "the family trust") which did not qualify for the marital deduction. Where more property passed to the marital deduction trust than was allowed as a marital deduction because of the 50-percent limitation of prior law, the trust was described as "overfunded." If the surviving spouse disclaimed this overfunded amount, the disclaimed amount would typically pass to the family trust in which the surviving spouse often was a beneficiary. Such a disclaimer would not be a qualified disclaimer under the general rule that the disclaimed interest must pass to persons other than the disclaiming person. In order to facilitate disclaimers by surviving spouses to prevent overfunded marital deduction trusts, Congress provided that the surviving spouse can make a valid disclaimer even though the surviving spouse receives an interest in the disclaimed interest.

pass either to the decedent's spouse or to a person other than the person making the disclaimer. As a result, a disclaimer that is ineffective under local law could not be treated as a qualified disclaimer for purposes of Federal estate and gift taxes under prior law, even if the disclaimant timely transferred the property to the individual who, under local law, would have received the property if there had been an effective disclaimer. Because local disclaimer laws are not uniform, identical refusals to accept property could be treated differently for Federal estate and gift tax purposes, depending upon the applicable local law.

Thus, contrary to the original Congressional intent, prior law did not provide uniform treatment of disclaimers under Federal estate and gift tax law. In order to provide uniform treatment among states, the Congress concluded that, if an individual timely transfers the property to the person who would have received the property had the transferor made an effective disclaimer under local law, the transfer should be treated as an effective disclaimer for Federal estate and gift tax purposes provided the transferor has not accepted the interest or any of its benefits.

Explanation of Provision

Under the Act, a transfer of the transferor's entire interest in property to the person or persons who would have otherwise received the property if an effective disclaimer under applicable local law had been made is treated as a valid disclaimer for purposes of the Federal estate and gift taxes provided the transfer is timely made (sec. 2518(b)(2)) and the transferor has not accepted any of the interest or any of its benefits (sec. 2518(b)(3)).

A qualified transfer by an individual is a written transfer made by that individual within nine months of the transfer creating that individual's interest (or, if later, within nine months of the date the individual attains age 21) and before the individual accepts the interest or any of its benefits. A transfer will not be considered a transfer of the entire interest in the property if, by reason of the transfer, some or all of the beneficial enjoyment in the property returns to the transferor or the transferor has any power after the transfer to control the beneficial enjoyment from the property. Under prior and present law, a disclaimer with respect to an undivided portion of an interest is treated as a qualified disclaimer of the portion of the interest if the requirements are satisfied as to that portion of an interest. Similarly, under the Act, a transfer of an undivided portion of an interest is treated as a qualified disclaimer of that undivided portion provided the transfer of that portion otherwise satisfies the requirements of the Act.

The identity of the transferee is determined as though a valid disclaimer had been made under local law. However, the transfer need not be a valid disclaimer under applicable local law. In addition, the individual's transfer to the individual who would have taken under local law pursuant to an effective disclaimer is not to be construed as an acceptance of the property.

Effective Date

The provision applies to transfers (i.e., transfers creating an interest in the disclaiming person) made after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $5 million annually.

7. Repeal of deduction for bequests, etc. to certain minor children (sec. 427 of the Act and sec. 2057 of the Code)*

Prior Law

Prior to the enactment of section 2057, only transfers to charity and surviving spouses were treated more favorably than other testamentary transfers. With the enactment of section 2057 in the Tax Reform Act of 1976, the Congress intended to insure that a limited portion of a decedent's estate would be available, tax-free, to support an orphan during minority.

As enacted, section 2057 permitted a deduction only if a minor child had no known surviving parent and the decedent did not have a surviving spouse. The aggregate amount of the deduction allowed under this provision could not exceed an amount equal to $5,000, multiplied by the excess of 21 over the child's attained age, in years, on the date of decedent's death.

To insure that there was a reasonable correlation between the amount of the deduction and the amount received by the orphan, the deduction was permitted only if the property passed in certain specified forms. In order to qualify for the deduction, the property passing to an orphaned child could not be a terminable interest (such as a life estate) except that the property was permitted to pass to a person other than the child's estate if the child died before the youngest living child of the decedent attained age 23. In addition, amounts passing to a qualified minor's trust were eligible for the deduction.

Reasons for Change

The Congress understood that this provision substantially complicated estate planning and preparation of wills. Moreover, the Congress believed it more appropriate to provide tax-free amounts for eligible minor children through an increased unified credit. Because the Act raises the unified credit to $192,800, which will permit cumulative tax-free transfers of up to $600,000 after a phase-in period, the Congress concluded that the provision permitting a deduction for amounts passing to eligible minor children should be repealed.

Explanation of Provision

The Act repeals the deduction for certain amounts passing to minor children.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 427; H. Rep. No. 97-201 (July 24, 1981), p. 192; H.R. 4242, as passed by the House (July 29, 1981), sec. 427; and H. Rep. No. 97-215 (August 1, 1981), p. 256 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision applies to estates of decedents dying after December 31, 1981.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

8. Postponement of generation-skipping transfer tax effective date (sec. 428 of the Act and sec. 2006(c) of the Tax Reform Act of 1976)*

Prior Law

The Tax Reform Act of 1976, as modified by the Revenue Act of 1978, imposes a tax on generation-skipping transfers. A transitional rule exempted from the tax generation-skipping transfers occurring pursuant to wills or revocable trusts in existence on June 11, 1976, if (1) such wills and trusts were not amended after that date to create or increase the amount of the generation-skipping transfer and (2) the testator or trust grantor died before January 1, 1982.

Reasons for Change

The Congress concluded that it was appropriate to extend for one year the transitional rule exemption for certain generation-skipping trusts created by wills or revocable trusts in existence on June 11, 1976.

Explanation of Provision

The Act extends the transitional rule to exempt all generation-skipping trusts created by wills or revocable trusts in existence on June 11, 1976, if (1) such wills and trusts were not amended after that date to create or increase the amount of the generation-skipping transfer and (2) the testator or grantor dies before January 1, 1983.

Effective Date

The provision applies with respect to all transfers made after June 11, 1976, if (1) such wills and trusts are not amended after existence on that date.

Revenue Effect

The provision is estimated to have a negligible revenue effect.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8599-8600 (daily ed. July 28, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 257 (Joint Explanatory Statement of the Committee of Conference).

9. Credit against estate tax for certain transfer to Smithsonian Institution (sec. 429 of the Act)*

Prior Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes. Under prior law, there was no provision allowing a credit for estate tax purposes for transfers of property to the Smithsonian Institution.

Reasons for Change

The Congress believed that the Matthew Brady collection owned by the Estate of Dorothy Meserve Kunhardt should be purchased by the Smithsonian Institution. In addition, the Congress concluded that the purchase should be effected, in part, by granting an estate tax credit to the Estate equal to a portion of the purchase price.

Explanation of Provision

The Act provides a special credit against Federal estate taxes imposed on the Estate of Dorothy Meserve Kunhardt. The credit, which is effective as of the date on which the estate tax return was due to be filed, applies on the transfer to the Smithsonian Institution, within 30 days following the date of enactment of the Act (e.g., before September 13, 1981), of all of the right, title, and interests held by the Dorothy Meserve Kunhardt Trust and the Estate of Dorothy Meserve Kunhardt in the collection of approximately 7,250 Matthew Brady glass plate negatives and the Alexander Gardner imperial portrait print of Abraham Lincoln.

The amount of the credit is limited to the smallest of (1) the total estate tax imposed on the Kunhardt Estate, (2) the fair market value of the collection transferred to the Smithsonian Institution, or (3) $700,000.

Effective Date

The provision is effective on enactment of the Act (August 13, 1981). The credit allowed by the provision is effective as of the date on which the estate tax return for the Kunhardt Estate was due to be filed.

Revenue Effect

The provision is estimated to reduce budget receipts by less than $1 million in fiscal year 1982.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7805-06 (daily ed. July 16, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 256 (Joint Explanatory Statement of the Committee of Conference).

C. Other Gift Tax Provisions

1. Gift tax exclusions (sec. 441 of the Act and sec. 2503 of the Code)*

Prior Law

Under prior law, an annual exclusion from the gift tax of $3,000 per donee was allowed with respect to gifts of present interests in property. In addition, a gift made by a husband and wife may, with the consent of both, be treated for gift tax purposes as made one-half by each. The full amount of the exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property. Thus, if a husband and wife agreed to elect to treat gifts as made one-half by each (i.e., "split" gifts), prior law permitted them to make gifts up to $6,000 per donee each year without making a taxable gift.

Reasons for Change

The gift tax annual exclusion of $3,000 per donee was enacted by the Revenue Act of 1942. In establishing the exclusion, the Congress originally intended "to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts. . . ." (S. Rept. No. 665, 72d Cong., 1st Sess. (1932)). In view of the substantial increases in price levels since that date, the Congress believed that the gift tax annual exclusion should be increased to $10,000.

In addition, the Congress was concerned that certain payments of tuition made on behalf of children who have attained their majority, and of medical expenses on behalf of elderly relatives, technically could be considered gifts under prior law. The Congress believed such payments should be exempt from gift taxes without regard to the amounts paid for such purposes.

Explanation of Provision

In general, the Act increases the gift tax annual exclusion to $10,000 per donee. With gift-splitting, spouses may make gifts of up to $20,000 per donee each year without making a taxable gift.

In addition, the Act provides that any amounts paid on behalf of any individual (1) as tuition to certain educational organizations for the education or training of such individual or (2) as payment for medical care to any person who provides medical care (as defined in sec. 213(e)) with respect to such individual will not be

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 403; S. Rep. No. 97-144 (July 6, 1981), pp. 129-130; H.R. 4242, as reported by the House Ways and Means Committee, sec. 441; H. Rep. No. 97-201 (July 24, 1981), pp. 193-194; H.R. 4242, as passed by the House (July 29, 1981), sec. 441; and H. Rep. No. 97-215 (August 1, 1981), p. 257 (Joint Explanatory Statement of the Committee of Conference).

considered transfers subject to gift taxes. This exclusion for medical expenses and tuition is in addition to the $10,000 gift tax annual exclusion and is permitted without regard to the relationship between the donor and the donee.

The exclusion for medical expenses (including medical insurance) applies only with respect to direct payments made by the donor to the individual or organization providing medical services or paying as an insurer. Thus, the amount of any reimbursement to the donee, as intermediary, is not excludable except to the extent that the $10,000 annual exclusion amount is available. Qualifying medical expenses are limited to those defined in section 213 (i.e., those incurred essentially for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body). However, medical expenses are excludable from gift tax without regard to the percentage limitation contained in section 213.

The unlimited exclusion is not permitted for amounts that are reimbursed by insurance. Thus, if a donor pays a qualifying medical expense and the donee also receives insurance reimbursement, the donor's payment, to the extent of the reimbursement, is not eligible for the unlimited exclusion whether or not such reimbursement is paid in the same or subsequent taxable year.

With respect to educational expenses, an unlimited exclusion is permitted for tuition paid on behalf of an individual directly to the qualifying educational institution providing such education. A qualifying organization is an educational organization described in section 170(b)(1)(A)(ii), i.e., an institution which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The exclusion is permitted with respect to both full- and part-time students, but is limited to direct tuition costs. Thus, the unlimited exclusion does not apply to amounts paid for books, supplies, dormitory fees, etc.

In providing an unlimited exclusion for certain medical expenses and tuition, the Congress did not intend to change the rule that there is no gift for gift tax purposes if the person who pays medical expenses or tuition is under an obligation under local law to provide such items to the recipient. In addition, the Act does not change the income tax consequences otherwise applicable to such payments.

Effective Date

In general, the changes to the gift tax annual exclusion apply to transfers made after December 31, 1981.

Many existing trusts provide powers of appointment specifically defined in terms of the section 2503(b) gift tax annual exclusion which, under prior law, was limited to $3,000. The Congress was concerned that many settlors, although limiting the power by reference to section 2503(b), may not have wanted to provide a power over property in excess of $3,000.[1] For this reason, the Act contains

[1] Sections 2041 and 2514 provide that the lapse of a power to appoint property with a value greater than $5,000 or five percent of the assets out of which the power could have been satisfied is treated as a taxable release of the power. The Congress understood that it was

a transitional rule that the increased gift tax annual exclusion does not apply to powers granted under a trust created before 30 days after the date of enactment (e.g., before September 30, 1981) and not amended after that date provided that (1) the power is exercisable after December 31, 1981, (2) the power is defined in terms of the section 2503(b) gift tax annual exclusion, and (3) there is not enacted a State law applicable to such instrument which construes the power of appointment as referring to the increased gift tax annual exclusion provided by the Act.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $123 million in 1982, $204 million in 1983, $201 million in 1984, $187 million in 1985, and $175 million in 1986.

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common for parents to establish a trust where the only present interest granted to the children is a right to withdraw a specific amount not to exceed the "five and five" powers. Parents would normally contribute an amount not to exceed the amount eligible for the sec. 2503(b) exclusion ($3,000 under prior law) and, consequently, the amount of the lapse would not be treated as a taxable release under the "five and five" powers. The Congress did not believe that, as a matter of consistency, the "five and five" powers should be increased to $10,000.

2. Annual payment of gift tax (sec. 442 of the Act and secs. 1015, 2501, 2502, 2503, 2504, 2505, 2512, 2513, 2522, 1015, 6019, 6075, and 6212 of the Code)*

Prior Law

Prior to 1971, gift tax returns were required to be filed, and any gift tax liability paid, on an annual basis.[1] For gifts between 1971 and 1976, gift tax returns were required to be filed, and any gift tax liability paid, on a calendar quarter basis.

For gifts made after December 31, 1976, a gift tax return was required to be filed, and any gift tax paid, on a quarterly basis if the sum of (1) the taxable gifts made during the calendar quarter plus (2) all other taxable gifts made during the calendar year (and for which a return had not yet been required to be filed) exceeded $25,000.[2] If a gift tax return was required to be filed for a calendar quarter, the gift tax return was due, and any gift tax payable, on or before the 15th day of the second month following the close of the calendar quarter. If all transfers made in a calendar year that were subject to the gift tax filing requirements did not exceed $25,000 in taxable gifts, a return was required to be filed, and any gift tax paid, by the filing date for gifts made during the fourth calendar quarter of the calendar year.

For gifts made after December 31, 1979, the due date for an annual return or a return for the fourth calendar quarter was conformed to the due date for filing individual income tax returns, i.e., April 15 of the following year.

Reasons for Change

The Congress believed that the quarterly filing requirement for gift tax returns caused confusion and undue administrative burdens for taxpayers and the Internal Revenue Service. Accordingly, the Congress concluded that returns should be filed on an annual basis.

Explanation of Provision

The Act provides that gift tax returns are to be filed, and any gift tax paid, on an annual basis.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 442; H. Rep. No. 97-201 (July 24, 1981), pp. 195-196; H.R. 4242, as passed by the House (July 29, 1981), sec. 442; and H. Rep. No. 97-215 (August 1, 1981), p. 257 (Joint Explanatory Statement of the Committee of Conference).

[1] Prior to enactment of the Excise, Estate and Gift Tax Adjustment Act of 1970 (Public Law 91-614), the due date for filing a gift tax return was April 15 following the calendar year in which a gift was made. In general, the 1970 Act required the quarterly filing of gift tax returns (by the 15th day of the second month following the close of the calendar quarter) to provide for the more current payment of gift tax liabilities.

[2] In the case of nonresidents who are not U.S. citizens, the same rule applied, except that $12,500 was substituted for $25,000.

In general, the due date for filing the annual gift tax return is April 15 of the following year. However, the gift tax return for the calendar year in which the donor dies must be filed no later than the due date for filing the donor's estate tax return (including extensions).

Effective Date

The provision applies with respect to gifts made after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $63 million in 1982 and by less than $5 million annually beginning in 1983.

TITLE V—TAX STRADDLES

1. Postponement of recognition of certain straddle losses (sec. 501 of the Act and secs. 1091 and 1233 and new sec. 1092 of the Code)*

Prior Law

In general

Prior to amendment by the Act, the Internal Revenue Code did not contain express statutory rules dealing specifically with straddle transactions. Two Code provisions preclude (1) loss recognition until a taxpayer's investment in certain types of property is terminated and (2) conversion of short-term capital gain into long-term capital gain. These wash-sale and short-sale rules either did not apply to positions in commodities and commodity futures contracts or did not significantly affect tax straddle transactions. The Internal Revenue Service interprets general principles of tax law as prohibiting tax straddle shelters; however, this interpretation has been challenged by some taxpayers. In adding specific statutory rules in the Act to govern the taxation of straddle transactions, the Congress has supplemented the prior law, generally without changing or reinterpreting those rules which remain in effect.

Recognition of gain or loss

Under the tax law existing prior to the Act and generally continuing in effect now, gain or loss on property is recognized by the taxpayer at the time of a sale or other disposition of the property, unless there is specific statutory provision for nonrecognition (sec. 1001). However, losses of individuals are allowable only if incurred in a trade or business, incurred in a transaction entered into for profit, or resulting from casualty or theft (sec. 165(c)). Further, losses are recognized only if from a closed and completed transaction.

Wash sales

The Code includes a wash-sale rule providing for nonrecognition of certain losses from the sale or exchange of stock and securities if the taxpayer has not terminated his investment in the loss property (sec. 1091).

The wash-sale rule disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option or contract to acquire such stock or securities) are

*For legislative background of the Title V provisions, see: H.J. Res. 266, as reported by the Senate Finance Committee, secs. 501-508; S. Rep. No. 97-144 (July 6, 1981), pp. 143-171; Senate floor amendments, 127 Cong. Rec. S8214-17 and S8265-67 (daily ed. July 23, 1981); H. R. 4242, as reported by the House Ways and Means Committee, secs. 501-507; H. Rep. No. 97-201 (July 24, 1981), pp. 197-214; H. R. 4242, as passed by the House (July 29, 1981), secs. 501-507; H. Rep. No. 97-215 (August 1, 1981), pp. 258-260 (Joint Explanatory Statement of the Committee of Conference); and S. Con. Res. 30, 127 Con. Rec. S9270 (Aug. 3, 1981) and H5993 (Aug. 4, 1981) (daily ed.).

acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date. This provision prevents a taxpayer from selling stock which has declined in value in order to establish a loss for tax purposes, but then immediately reacquiring substantially identical stock, because the sale and reacquisition together do not significantly alter the taxpayer's position in that stock.

This wash-sale rule applies with respect to the disposition of stock or securities only. Commodity futures are not treated as stock or securities (Rev. Rul. 71-568, 1971-2 C.B. 312).

Capital gains and losses

Certain gains and losses from the sale or exchange of a capital asset [1] are eligible for special treatment. In the case of individuals, only 40 percent of the excess of net long-term capital gain over net short-term capital loss for the taxable year is included in the taxpayer's adjusted gross income (sec. 1202). In addition, capital losses of individuals are deductible in full against capital gains and against up to $3,000 of ordinary income each year (sec. 1211(b)). Only 50 percent of the net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. Capital losses in excess of this limitation may be carried over to future years indefinitely, but may not be carried back to prior years (sec. 1212(b)).

In the case of a corporation, the net capital gain is taxed at an alternative rate of 28 percent (sec. 1201). Capital losses are allowed only against capital gains (sec. 1211(a)). Any excess loss may be carried back three years and forward five years (sec. 1212(a)).

Generally, in order for gains or losses on a sale or exchange of capital assets to be considered long-term capital gains or losses, the assets must be held for one year or more.[2] In the case of futures transactions in any commodity subject to the rules of a board of trade or commodity exchange, the required holding period was six months.[3] (This special six-month holding period continues to apply to any futures contract which is part of a mixed straddle which is not marked-to-market under the new section 1256, added by the Act.)

Short sales

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property), any gain or loss on the closing transaction

[1] Sec. 1221. Capital assets generally include all property held by the taxpayer other than inventory, depreciable or real property used in a trade or business, certain taxpayer-created property, and certain receivables. Prior to the Act, certain short-term government obligations were treated as ordinary income property. Section 505 of the Act reclassifies these obligations as capital assets.

For this purpose, commodity futures contracts may not qualify as inventory. However, they are not allowed capital gains treatment if used as an integral part of the taxpayer's business, such as in farming or food processing. *Corn Products Refining Co.* v. *Comm'r*, 350 U.S. 46 (1955).

[2] Generally, options held for investment are governed by the same Code provisions as are other capital assets. However, sec. 1233(c) exempts certain options to sell property from the short sales rules if the option was acquired on the same day as the property and the option, if exercised, is exercised through the sale of the property. Section 1234 provides that gain or loss from the sale or exchange of an option has the same character as gain or loss from the sale or exchange of the property underlying the option, if the property were in the hands of the taxpayer. Gain or loss from closing transactions in options is treated as short-term capital gain or loss.

[3] Sec. 1222.

is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)), but the gain ordinarily is treated as short-term gain (sec. 1233(b)(1)).[4] Entering into a contract to sell is treated as a short sale for purposes of these rules.[5]

The Code contains several rules which were intended to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale is considered short-term gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)). These rules preclude the taxpayer from "aging" his holding period so as to convert short-term capital gain into long-term capital gain where the taxpayer is free of any significant risk of loss. Also, if a taxpayer has held property for more than one year and sells substantially identical property short, any loss on the closing of the short sale is considered long-term capital loss (sec. 1233(d)). This rule prevents the conversion of long-term capital loss into short-term capital loss.

For purposes of these rules, property includes stock, securities, and commodity futures (sec. 1233(e)(2)(A)), but commodity futures are not considered substantially identical if they call for delivery of the commodity in different calendar months (sec. 1233(e)(2)(B)). In addition, these rules do not apply in the case of hedging transactions in commodity futures (sec. 1233(g)).

Straddles

Prior to the Act, the Code did not contain any special rules dealing with straddles in commodities or commodity futures contracts.[6] In the case of the typical straddle in commodities (i.e. the acquisition of a contract to buy a commodity in one month and the acquisition of a contract to sell the same commodity in a different month), neither the wash sale rule applicable to stocks or securities (sec. 1091), nor the special short sales rules preventing conversion of short-term gain to long-term gain or long-term losses to short-term losses (secs. 1233 (b) and (d)), apply.

However, the Internal Revenue Service had ruled that the loss from certain silver futures contracts constituting part of a straddle was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions" (Rev. Rul. 77-185, 1977-1C.B. 48).[7] The ruling also stated that the loss

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[4] However, if on the date of a short sale, the taxpayer has held substantially identical property for over a year, a loss on the closing of the short sale will be treated as a long-term capital loss (sec. 1233(d)).

[5] Thus, in any commodity futures contract transaction prior to the Act, or any such transaction which occurs after the Act but which involves contracts not marked-to-market under new section 1256, the person holding the obligation to sell generally may recognize only short-term capital gain or loss from that position (sec. 1233(b)(1).

[6] Section 1222 provides a six-month holding period for regulated commodity futures contracts. Section 465 contains rules limiting losses from an activity to amounts which certain taxpayers have "at-risk" in that activity. These rules are generally applicable to all activities, other than real estate, in taxable years beginning after 1978. It is unclear whether the section 465 rules limit deductions for losses related to straddles.

[7] In the transaction described in the Revenue Ruling, the taxpayers on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts

claimed on the disposition of one leg of the straddle was not a loss from a closed and completed transaction. This ruling has been the subject of controversy and the Revenue Service is litigating the deductibility of certain losses claimed in straddle transactions.

Reasons for Change

The possibility that certain transactions called spreads or straddles might afford taxpayers an opportunity to defer income and to convert ordinary income and short-term capital gain into long-term capital gain had been recognized by the investment industry for decades. In the last ten to fifteen years, the use of such tax shelters in commodity futures had extended beyond investment professionals to significant numbers of taxpayers, individual and corporate, throughout the economy. The tax advantages of spread transactions, especially those structured in commodity futures contracts, were touted in commodity manuals, tax services, and financial journals. Brokerage firms promoted tax spreads or straddles to their clients. Domestic and offshore syndicates advertised tax straddle shelters for which purchasers paid a fee in an amount equal to a percentage of their desired tax loss.

Simple commodity tax straddles generally had been used to defer tax on short-term capital gain from one tax year to the next tax year and, in many cases, to convert short-term capital gain realized in the first year into preferentially taxed long-term capital gain in a later year. However, in some cases straddles were used to defer tax on ordinary income and convert that income into short- or long-term capital gain (see discussion of straddles in Treasury bill futures contracts, below). A simple commodity straddle is constructed by taking equal long and short positions in futures contracts in the same commodity with different delivery dates. The two positions, called "legs," are expected to move in opposite directions but with approximately equal absolute changes. Thus, for example, if one leg of a straddle in futures contracts increases $500 in value, the other leg can be expected to decrease in value by about the same amount. By maintaining balanced positions, the risks of the transaction are minimized.

Four considerations motivated the Congress to take action at this time. First, the use of tax straddles already had received substantial public attention. The result was that a broad perception already had arisen that it was possible—indeed, perhaps legitimate—to pay no tax at ordinary income rates. The Congress recognized the adverse effects of such a perception and believed that an immediate response to taxpayer attempts to achieve conversion and deferral through commodity transactions was necessary.

Second, the Congress believed that the revenue loss might grow substantially because of the low transaction costs and significant leverage available in many commodity futures transactions. Thus, the revenue loss from a failure to act would have been substantial.

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were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

Third, the widespread tax sheltering activity threatened substantial disruption in the commodity markets. The tax benefits allegedly available through commodity transactions were leading many taxpayers to engage in transactions that were otherwise uneconomic, with a resulting distortion of supply and demand curves. The percentage of tax-motivated transactions in certain markets was already very substantial. The marked increase in the number of demands for delivery on Treasury bill futures contracts, noted in recent Decembers, had been linked to tax-motivated transactions and had been blamed for causing some distortion of the market.

Fourth, taxpayers confronted unnecessary uncertainty in ascertaining the tax consequences of transactions in the area of futures and forward contracts. Greater simplicity in the rules governing such transactions and greater certainty about the results of common transactions appeared essential.

The Congress believed that commodity futures markets play an important role in the economy. These markets provide a valuable means for farmers to reduce their risks in the production of crops and for bulk consumers to hedge their risks of price shifts. There has been explosive growth in the futures market over the past decade, and there is good evidence that such growth will continue. Because of the importance of the commodities markets, particularly in the agricultural and commercial sectors, the Congress considered it critical that the efficiency of these markets be preserved and the liquidity of these markets maintained. Thus, for example, the Congress created an exception to the new rules for hedging transactions.

The Congress believed that the changes which it made affirm general principles of present law. Fundamentally, the new rules require that commodity futures transactions be taxed on their economic substance.

Explanation of Provision

Loss deferral rule

General rules

The Act provides rules to prevent deferral of income and conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions. Generally, the deduction of losses on positions which are part of a straddle is limited to the amount by which such losses exceed unrealized gains on any offsetting positions. As described in detail below, straddles subject to these rules are offsetting positions consisting of actively traded personal property other than stock, positions in such personal property, and certain stock options. In addition, the Act authorizes the Treasury Department to prescribe regulations applying to straddle gains and losses rules similar to those in subsections (a) and (d) of section 1091 (relating to wash-sales) and those in subsections (b) and (d) of section 1233 (relating to short sales).

Under the Act, a taxpayer's straddle losses are deferred to the extent the taxpayer has unrealized gains in offsetting positions. If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of loss which may be deducted is the excess of the loss over the unrealized gain (if any) in positions

which offset the loss positions and which were acquired before the taxpayer disposed of the loss position. Losses on positions in straddles which the taxpayer properly identifies as identified straddles, within the definition in section 1092(a)(2)(B), are not subject to this loss deferral rule, but only if all positions in the identified straddle remain open at the end of the taxable year or all such positions are disposed of on the same day. Losses on identified straddles are treated as sustained no earlier than the day on which all positions in the identified straddle are closed.

Losses deferred under the loss deferral rule are carried forward to the succeeding year and are subject to the application of the deferral rule in that succeeding year. Deferred losses are recognized in the first taxable year in which there is no unrealized appreciation in offsetting positions acquired before the disposition of the loss position.

Allocation of losses.—The Treasury will have to prescribe regulations to deal with the situation in which the realized loss on the loss legs of a straddle exceeds the unrealized gain on the gain legs. These regulations will provide rules for allocating the losses among the unrealized gain positions and determining which of the losses will be deductible and which will be deferred. The Congress intended that allocation of losses to unrealized gain positions be done in a consistent manner that does not distort income. It is expected that regulations issued under this Act will provide that one dollar of unrealized appreciation at the end of any year defers at most only one dollar of realized loss.

Identified straddles

Under the Act, identified straddles are exempted from the loss deferral rules and are taxed under special rules. Further, since positions which are part of an identified straddle do not offset any positions not included in the identified straddle, no position within an identified straddle will defer losses or require capitalization of carrying costs as to any position not included in the identified straddle. Losses on positions which make up an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all positions comprising such a straddle.

To be treated as an identified straddle, the straddle must be clearly marked as an identified straddle on the taxpayer's records before the close of the day it is acquired. All of its positions must be acquired on the same day, and it must either have all of its positions closed of the same day during the taxable year or it must have no positions closed before the end of the taxable year. If a successor or substitute position replaces an original position in the straddle (including a case where a loss is disallowed because of the wash-sale rule under sec. 1092(b)), the straddle ceases to qualify as an identified straddle. Thus, for example, if a taxpayer disposes of a position that is part of an identified straddle at a loss and the loss is disallowed under the wash-sale rule because the position is replaced, other losses sustained on positions not part of the identified straddle may be disallowed because of unrealized gain on positions within the identified straddle. In addition, an identified straddle cannot constitute part of a larger straddle (for example, a butterfly).

Straddles in regulated futures contracts

A straddle comprised entirely of regulated futures contracts is not subject to the loss deferral rule. Such straddles will be taxed under the mark-to-market system (described below).

Mixed straddles

If a straddle is composed partially of regulated futures contracts and partially of other positions (called a "mixed straddle"),[8] losses from positions that are part of the straddle will be subject to the loss deferral rule or to the rule relating to identified straddles. The mixed straddle will be subject to the loss deferral rule, if it is not an identified straddle, whether or not the taxpayer elects that the regulated futures contracts in the straddle be on or off the mark-to-market system under section 1256(d). Thus, the taxpayer will have essentially three choices in the case of a mixed straddle. First, he may choose that the regulated futures contracts be marked-to-market, in which case the straddle will be subject to the loss deferral, wash-sale, and short-sale rules. Second, if the taxpayer designates the positions as a mixed straddle, the regulated futures contracts will be excluded from the mark-to-market system but subject to the loss deferral, short-sale, and wash-sale rules. Third, if the straddle otherwise satisfies the conditions of an identified straddle, and if the taxpayer designates the straddle as a mixed straddle and further elects that it be an identified straddle under the identified straddle rules, the regulated futures contracts will be exempted from the mark-to-market rules, and the straddle will be exempted from the loss deferral rules but subject to the identified straddle, wash-sale, and short-sale rules. In this connection, a mixed straddle as discussed in this explanation may include positions acquired on different days. As stated above, a taxpayer may not elect to treat positions acquired on different days as an identified straddle.

Unrealized gain

In determining whether a taxpayer has deductible losses, the unrealized gain taken into account for a straddle position held by the taxpayer at the close of the taxable year shall be equal to the amount of gain which would be realized if the position were sold or otherwise liquidated at its fair market value on the last business day of the taxable year.[9] In the case of regulated futures contracts, fair market value is determined by the final settlement prices set by the futures exchanges for each contract on the final trading day of the year. In the case of a mixed straddle in which the taxpayer has not elected out of mark-to-market treatment for the regulated futures contract, losses exceeding unrealized gains not marked to market are deductible without diminution by reason of gains taken into account by virtue of the mark-to-market system. The settle-

[8] In new section 1256(d)(4), the term "mixed straddle" is defined, for purposes of subsection (d), to refer only to straddles designated as mixed straddles. In this explanation, however, the term "mixed straddle" refers to all straddles composed partly of regulated futures contracts and partly of other positions, whether or not they are identified as straddles by the taxpayer.

[9] The deferral of straddle losses is intended to preclude the deduction of losses until offsetting gains are taken into account for tax purposes. Accordingly, if by the close of the taxable year the taxpayer has economically disposed of both a loss position and an offsetting gain position that is not taken into account until the following year, the loss will not be allowed until the following year under the loss deferral rule.

ment price applicable in the case of positions that are not regulated futures contracts will normally be dispositive of fair market value as well.

Disclosure of unrealized gains

To verify the amount of loss deductible by the taxpayer, the taxpayer's unrealized gains must be disclosed. The Act requires taxpayers to disclose all their positions which have unrealized gain at the close of the taxable year and the amount of unrealized gain in each of the positions. Positions with unrealized gain must be disclosed whether or not the positions are part of a straddle.

Taxpayers will not be required to file disclosure reports on unrealized gains if they have sustained no loss on any position (including regulated futures contracts) during the taxable year, or if the only loss sustained was a loss on inventory or depreciable trade or business property described in paragraph (1) or (2), respectively, of section 1221. No disclosure report is required for any positions which are part of an identified straddle. Further, taxpayers who sustain losses from the disposition of long positions and who have neither disposed of nor hold any short positions, whether as options, regulated futures contracts, forward sales, or otherwise, generally would not hold offsetting positions and would not be expected to report unrealized gain.

A taxpayer whose loss from a disposition of a short position in a prior year was deferred under section 1092 may have offsetting positions in the current year as a result of the carryover of such loss under section 1092(a)(1)(B) and therefore would be required to report unrealized gains. Additionally, a taxpayer is not required to report unrealized gain in inventory positions or in depreciable trade or business property, or in hedging transactions (as defined by this Act in Code sec. 1256(e)). The Treasury is authorized to issue regulations prescribing the time, manner and form required for disclosure of such unrealized gains. The Congress intended that such disclosure be made on taxpayers' returns.

Wash sales; short sales

The Act requires that the Treasury issue regulations applying to straddle positions rules similar to certain provisions of the wash-sale rule (sec. 1091 (a) and (d)) and of the short-sale rule (sec. 1233 (b) and (d)). It is intended that the wash-sale rule be applied in appropriate cases to disallow losses in certain straddle transactions prior to the application of the loss deferral rule of new section 1092, and that the time period applicable under the existing wash-sale rule (from 30 days before to 30 days after the date of sale) would be the appropriate time interval under these new rules.

In the typical tax-shelter straddle transaction, for example, the taxpayer, after disposing of the loss leg, immediately replaces it in order to remain in a balanced position and protect the unrealized gain. In this case, the modified wash-sale rule to be prescribed by regulations will prevent deduction of the loss. Thus, the loss deferral rule of section 1092(a) does not apply to this loss because section 1092(a) defers losses only if they are otherwise allowable. Any loss subsequently sustained on either leg of the reconstituted straddle may be deferred by application of new section 1092. Of course, an

adjustment must be made to the replacement leg analogous to the basis adjustment made under section 1091(d). Thus, in most cases, the disallowance of losses under the section 1091 rule will operate merely to defer the loss.

Under section 1233(b), gain on closing a short position generally results in short-term gain. In addition, the holding period of property held by the taxpayer which is substantially identical to the property sold short and not used to close the short sale does not commence until the short position is closed (unless the long-term holding period requirement was already satisfied for such property when the short position was created).

However, the holding periods of properties not satisfying the substantially identical standard of section 1233 were unaffected by its holding period rule under prior law even if they would constitute offsetting positions subject to the loss deferral rule of new section 1092. Section 1233(b) did not affect, for example, the typical tax-shelter commodity straddle because futures contracts calling for delivery in different calendar months were defined as not substantially identical (sec. 1233(e)(2)(B)). As a result, there was a possibility that a short-term gain could be converted into a long-term gain by creating a straddle if the "long leg" increased in value by holding the straddle for enough time to satisfy the long-term holding period requirement.

To prevent this result, the Act authorizes the Treasury to prescribe regulations adopting rules comparable to section 1233(b), and to apply such rules so that the holding period for property that is part of a straddle subject to the new rules of section 1092 is terminated and does not begin anew until the offsetting position or positions is disposed of. Thus, for example, if a taxpayer enters a short forward contract at a time when he has held an offsetting long position for less than 12 months, the holding period for such long position will be terminated and will not commence until the offsetting short position is disposed of. For purposes of these regulations, a futures contract to sell a commodity is equivalent to the short sale of a long futures contract for the same commodity or the short sale of the commodity itself. The regulations are also to adopt a rule comparable to section 1233(d), to prevent converting a long-term capital loss into a short-term capital loss.

Generally, the rules developed under the Act's delegation of regulatory authority to develop rules comparable to sections 1091 and 1233 will supplement and will have broader application than the original statutory rules in the two sections. In the new regulations, the concept of offsetting positions is to be substituted for the concept of substantially identical property. The application of the new regulatory rules under sections 1091 and 1233 is to supercede any application (or restriction on the application) of those sections in situations where both the new regulations and the original statutory law appear to apply.

Definition of straddle

The Act defines straddles as offsetting positions with respect to personal property. A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in

personal property because the taxpayer holds one or more other positions with respect to personal property.

Although the concept of offsetting positions is not narrowly defined in the statute, certain cases fall outside its scope. For example, risk reduction through mere diversification usually would not be considered to substantially diminish risk for purposes of this Act, if the positions are not balanced. Thus a taxpayer holding several types of securities but holding no short positions generally would not be considered to be holding offsetting positions.

Positions in personal property may be treated as offsetting whether or not the underlying property is the same kind. Thus, a straddle can consist of two futures contracts, one to take delivery and the other to make delivery of silver, a long futures contract for silver and a short forward contract for silver coins, or a long futures contract for soybean meal and a short futures contract for soybean oil. A straddle also may consist of two positions which are not the same type of interest in property. A straddle may be made up of a cash position in silver, i.e., holding the physical commodity itself, and of a futures contract to sell the same amount of silver. It may also be made up of an option to acquire a long futures contract and a short futures contract.

In cases where one or more positions offset only a portion of one or more other positions, they should be treated as offsetting and subject to the rules in section 1092 only to the extent of the portion of the position or positions which is balanced. The Act authorizes the Treasury to issue regulations prescribing the method for determining the portion of a position which is to be taken into account as offsetting. In appropriate cases, therefore, only part of the loss from a single position may be treated as subject to the loss deferral rules. However, no position which is not a part of an identified straddle may be treated as offsetting with respect to any position which is part of an identified straddle.

Also, under the Act, taxpayers are presumed to hold offsetting positions in certain specified circumstances. The first presumption provides that positions in the same personal property, whether in the physical commodity itself or in a contract for the commodity, are considered offsetting positions, provided the values of the positions vary inversely with each other. Generally, values vary inversely if the value of one position decreases when the value of the other position increases. A straddle in silver futures contracts or forwards, or a straddle in cash silver and a futures contract to sell silver, falls within this presumption.

The second presumption covers positions in the same personal property, even though the property may be in a substantially altered form, provided the values of the offsetting positions ordinarily vary inversely with respect to each other.

The third presumption covers positions in debt instruments of similar maturities if the positions ordinarily vary inversely in value in relation to each other. Generally, debt instuments are considered to be of a similar maturity if the scheduled maturities are in sufficiently close proximity to each other that a change in value of one instrument will correspond substantially to a change in value of the other. The Treasury may prescribe regulations describing other types of positions in debt instruments which will

be presumed to be offsetting, provided the inverse variation test is passed.

The fourth presumption treats positions which are sold or marketed as offsetting positions as straddles. The presumption does not depend on the positions being labelled by any particular name, such as straddle, spread, or butterfly.

The fifth presumption provides that positions are presumed offsetting if the aggregate margin requirement for such positions ordinarily is lower than the sum of the margin requirements for each of the positions, if held separately. Thus, if the value or amount of the deposit, pledge, payment, security, or other requirement for holding two or more positions together ordinarily is less than the cost of holding each alone, this presumption applies. Generally, the lower margin for the aggregate holdings is evidence that there is less economic risk associated with holding the combined positions than with holding each of the positions separately.

The Act also authorizes the Treasury to issue regulations prescribing other factors, including subjective or objective tests, to establish a presumption that positions are offsetting. The values of positions presumed offsetting under this regulatory authority ordinarily must vary inversely. This authority enables the Treasury to develop presumptions which treat complex or innovative types of straddles as offsetting positions. The Act makes clear that such regulations may describe factors to be applied in determining whether positions are offsetting or may prescribe categorical tests for such determination.

Any presumptions established under the Act's specific rules or under the regulatory authority provided by the Act can be rebutted by the taxpayer or by the Government.

Definitions and special rules

The Act defines personal property as any personal property, other than stock, of a type which is actively traded. A position is an interest in personal property, including a futures contract, a forward contract, or an option. In addition to corporate stock, the Act does not apply to real property or to property which is not actively traded. U.S. currency does not constitute personal property as defined since only property or interests in property that may result in gain or loss on their disposition are subject to the straddle limitations. Further, a futures contract, forward contract, option (other than a stock option) or other interest, while constituting a position in other property, is also personal property as defined in the Act if it is actively traded. Thus, for example, a debt instrument is a contractual right entitling its holder to an amount of cash on a future date and also constitutes personal property if it is actively traded. Similarly, a futures contract that does not require delivery of personal property but calls for a cash settlement predicated on the future price of deposits, obligations, stock, securities, or other assets is itself personal property if actively traded. In order to be treated as actively traded, property need not be traded on an exchange or in a recognized market.

The term "position" includes options to buy or sell stock if such stock is actively traded, provided either that the period during which the option may be exercised exceeds the period required for

long-term capital gain treatment or that the options are not traded on a domestic or designated foreign exchange. Thus, the Act's major rules apply to offsetting positions in stock options which can be held for more than 12 months. The definition of position excludes, and thus the major rules are inapplicable to, stock options traded on United States exchanges or similar foreign exchanges designated by the Secretary, if the options have an exercise period less than the minimum time required to hold a capital asset to produce long-term capital gain or loss.

An attribution rule treats positions which are held by a person related to the taxpayer as positions held by the taxpayer. Persons related to the taxpayer are the taxpayer's spouse and a corporation which files a consolidated return with the taxpayer under section 1501. In addition, certain positions held by flow-through entities, such as trusts, partnerships, or subchapter S corporations, are treated as held by the taxpayer. If part or all of the gain or loss from a position held by a flow-through entity would be properly taken into account in determining the taxpayer's own Federal tax liability, the position is treated as held by the taxpayer, unless the regulations provide otherwise.

New section 1092(a) providing for deferral of certain losses and the regulations to be issued under this Act to apply wash-sale (sec. 1091) and short-sale (sec. 1233) principles to straddle transactions do not apply to hedging transactions. The hedging transactions excepted from these rules also are excepted from the Act's mark-to-market and capitalization rules (see below.) Hedging is defined in the mark-to-market provisions (sec. 1256(e)) and refers to certain risk-limiting transactions conducted in the normal course of the taxpayer's trade or business which produce ordinary income or ordinary loss. A transaction qualifies for the exception only if it is clearly identified by the taxpayer as being a hedging transaction before the close of the day on which the transaction is executed. It is expected that taxpayers, such as banks or securities dealers, which may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items.

Penalty for failure to disclose gains

Under the Act, taxpayers who without reasonable cause fail to report all of their unrealized gains are subject to a penalty, if they have a tax deficiency attributable in whole or in part to the denial of a loss deduction because they hold an offsetting position with unrealized gain. The penalty for the failure to report unrealized gain is treated as a penalty attributable to negligence or intentional disregard of rules and regulations (but without intent to defraud) in section 6653(a). The penalty assessed is the amount equal to five percent of the underpayment. In addition, a penalty equal to 50 percent of the interest payable under section 6601 on that portion of the underpayment attributable to the negligence or intentional disregard is also imposed under section 6653(a)(2), as added by the Act. The period for computing this additional penalty commences

on the date prescribed for payment of the underpayment and ends on the date of assessment.

Thus, for example, if a taxpayer who does not report all unrealized gain positions has an underpayment because the taxpayer is determined to have held an offsetting unrealized gain position, the taxpayer must pay the penalty, even if the taxpayer obtained a counsel's opinion that the unrealized gain did not offset the loss. To avoid the penalty, a taxpayer claiming a deduction for the loss may rely on the opinion, but the taxpayer also must disclose all unrealized gain positions and must indicate that none of the disclosed gain positions is considered an offsetting position.

Effective Date

The changes made by this provision generally apply to property acquired and positions established by the taxpayer after June 23, 1981.

Election

Taxpayers may elect under section 508 of the Act to apply the new rules governing the taxation of straddles, including the provisions of both sections 1092 and 1256, to all positions held on June 23, 1981, for the periods after that date. The election must cover all positions, whether in regulated futures contracts or in other property, held by the taxpayer on that date. (This and other elections under Title V of the Act are discussed in more detail below.)

2. Capitalization of certain interest and carrying charges (sec. 502 of the Act and sec. 263 of the Code)

Prior Law

Under prior law, carrying charges, such as storage, insurance, and interest on indebtedness incurred or continued to purchase or carry a commodity held for investment, were deductible as an expense paid or incurred for the management, conservation, or maintenance of property held for the production of income (secs. 163 and 212), notwithstanding that the taxpayer held an offsetting position to minimize risk and may have claimed long-term capital gain on the sale of the commodity.

However, a limitation was imposed under section 163(d) on interest on investment indebtedness. This limitation was not changed by the Act and remains in effect. Generally, the deduction for such interest is limited to $10,000 per year plus the individual taxpayer's net investment income. Any remaining amount can be carried over to future years.

Reasons for Change

The Congress believed that the use of certain straddles which were executed with deductible financing and carrying charges, to defer ordinary income and to convert it into long-term capital gain, had become a serious tax-avoidance problem threatening substantial revenue losses. The Congress decided to discourage these transactions, sometimes called "cash and carry" shelters, in this legislation.

"Cash and carry" tax shelters usually involved the purchase of a physical commodity, such as silver, and the acquisition of a futures contract to deliver (sell) an equivalent amount of the same commodity more than twelve months in the future. The taxpayer financed the purchase with borrowed funds, and deducted the interest expense, storage, and insurance costs in the first year. These ordinary deductions offset ordinary investment income, e.g., interest and dividends.

Because the price differential between the current (or spot) price of the physical commodity and the price of the futures contract for a distant month is largely a function of interest and other carrying charges, the futures contract has a contract price approximately equal to the total payment for the physical commodity plus interest and carrying costs.

A taxpayer executing a cash and carry shelter acquired the silver and the offsetting contract in one year and held them into the next year. When the 12-month holding period qualifying the physical commodity for long-term treatment had elapsed, the silver could be delivered to satisfy the taxpayer's obligation under the futures contract, thereby realizing a gain on the silver. If the price of silver had increased, the taxpayer could sell the silver, produc-

ing long-term capital gain, while closing out the short futures position, creating a short-term capital loss. In either event, the net gain on the two positions was about equal to the interest and carrying charges paid during the period the commodity was held, but was reported as long-term capital gain. Thus, in 1979, for example, investment income taxable at rates as high as 70 percent, might have been deferred for a year and converted into capital gains taxable at maximum rates no higher than 28 percent. (The Act also reduced the maximum rate on investment income from 70 to 50 percent in 1982, which results in the reduction of the maximum long-term capital gains rate from 28 to 20 percent.)

Because the Congress recognized that certain legitimate business transactions, such as hedging, which result only in ordinary income or loss, lack significant tax avoidance potential, it exempted such activities from the Act's rules on "cash and carry" transactions.

Explanation of Provision

The Act requires taxpayers to capitalize certain otherwise deductible expenditures for personal property if the property is held as part or all of an offsetting position belonging to a straddle. Such expenditures must be charged to the capital account of the property for which the expenditures are made. Thus, these expenditures will reduce the gain or increase the loss recognized upon the disposition of the property.

Expenditures subject to this capitalization requirement are interest on indebtedness incurred or continued to purchase or carry the property, as well as amounts paid or incurred for insuring, storing or transporting the property. The amount of expenditures, called carrying charges, to be capitalized is reduced by any interest income from the property (including original issue discount) which is includible in gross income for the taxable year, and any amount of ordinary income acquisition discount (new sec. 1232(a)(4)(A)) includible in gross income for the taxable year.

The capitalization requirements do not apply to any identified hedging transactions (sec. 1256(e)) or to any position which is not part of a straddle. Thus, for example, a farmer still can deduct currently the costs of financing crops. Similarly, securities dealers' expenses for financing their inventory and trading accounts which generate ordinary income or loss remain deductible currently.

Effective Date

The provision applies to property acquired and positions established by taxpayers after June 23, 1981, in taxable years ending after that date.

3. Regulated futures contracts marked to market and certain elections (secs. 503 and 509 of the Act and new sec. 1256 of the Code)

Prior Law

Prior to the Act, the Code did not contain any special rules dealing with straddles in commodities or in futures contracts for commodities. In the case of the typical straddle in commodity futures contracts (i.e. the holding of a contract to buy a commodity in one month and the holding of a contract to sell the same commodity in a different month), neither the wash-sale rule applicable to stocks or securities (sec. 1091), nor the special short sales rules preventing conversion of short-term gain to long-term gain or long-term losses to short-term losses (secs. 1233 (b) and (d)), apply.

However, the Internal Revenue Service ruled that the losses on certain dispositions of silver futures contracts comprising part of a straddle were not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions". (Rev. Rul. 77-185, 1977-1 C.B. 48) This ruling has been the subject of controversy, and the Revenue Service is litigating the deductibility of certain losses claimed in straddle transactions.

Tax rules of general application which affect the taxation of transactions in commodity futures contracts are discussed in section 1., above.

Reasons for Change

Because of the rapid, significant growth in the use of tax straddles, especially those structured in commodity futures contracts, by high- and middle-income individuals as well as corporate taxpayers, the Congress believed it necessary to enact specific and simple statutory rules to prohibit any further attempts to use straddles in futures contracts for tax sheltering. The increase in tax sheltering through the use of commodity futures straddles threatened to undermine the integrity of the United States self-assessment system and to create substantial revenue losses. The seriousness of these dangers made it unwise to wait for a final judicial resolution of taxpayer-government disputes about the proper tax treatment of those transactions and imperative to eliminate any uncertainty about the tax rules for the future.

The Congress intended to prevent taxpayers from claiming the tax benefits which were allegedly obtained by using a futures straddle as a tax shelter.

A taxpayer using a simple futures straddle as a tax shelter would establish a position in contracts with contract prices of

about, say, $10,000 each. The two contracts, one to buy, the other to sell, were identical in every respect, except for their delivery months. Because the taxpayer's position was a straddle, his margin deposit was very low—as little as one percent of the value of the position ($200). The taxpayer would wait for the market to move, so that one leg of the straddle showed a loss, e.g., $500, and the other leg showed an almost identical gain. The taxpayer would liquidate the loss by entering into the opposite futures contract for the same month. (A contract to sell December wheat, for example, is liquidated by executing a contract to buy December wheat.) In order to maintain a balanced, minimal-risk position, the taxpayer would replace the liquidated leg with a contract which is identical, except for its delivery month. (The replacement contract would have a contract price of about $9,500, if the original long leg was liquidated at a loss, or a contract price about $10,500, if the original short leg was liquidated at a loss.)

The taxpayer would claim the decrease in value in the liquidated leg as a $500 short-term capital loss incurred in the year of liquidation thereby eliminating a $500 short-term gain for the tax year. At the same time, the taxpayer would continue to hold the other leg, which had an unrealized gain approximately equal to his "realized loss," that is, about $500. However, the taxpayer would not have made any payment on the liquidated leg because his account reflecting both long and short positions would show no net loss. In addition, because the taxpayer had maintained a balanced position, he ordinarily would not be required to deposit any additional margin into his margin account.

The taxpayer would hold the two legs into the following year. In the second year, the taxpayer would close out the two positions. Assuming the holdover contract would increase another $500 in value, the taxpayer would recognize a total gain of about $1,000 on the original leg and a loss of about $500 on the replacement leg. If the gain was on the long (buy) position and that position was held for over six months, the taxpayer would report a $1,000 long-term capital gain on the long position and a $500 short-term capital loss on the short position. If he had no other capital transactions for the year, he would report the $500 difference between these legs as long-term capital gain. (His margin, less commissions, would be returned.) Thus, he ostensibly succeeded in deferring his short-term capital gain for one year and converting it to a long-term capital gain. If the gain was in the short (sell) position, the gain would be short-term capital gain. In this case, the taxpayer ostensibly obtained a one-year deferral, but no conversion.

The Congress believed that the enactment of tax rules, based on the actual operations of futures trading, would end this use of futures for tax-avoidance purposes, would establish an accurate method of determining a taxpayer's futures income (or loss), and would ease tax administration and paperwork for both Government officials and taxpayers.

The United States commodity futures exchanges employ a unique system of accounting for every futures contract's gain or loss in cash on a daily basis. Even though a futures trader does not close out a position but continues to hold it, the trader receives any gain on the position in cash as a matter of right each trading day.

If a trader's position has increased in value during the day, the net increase in the position is computed and transferred to the trader's account before the beginning of trading the next day. The trader has the right to withdraw the full amount of such gains immediately every trading day. However, if a trader's position decreases in value, the trader will have to meet a margin call, that is, deposit additional funds, before the next business day. Money paid on position losses is paid into the exchange clearing association which transfers such amounts to accounts which gained during the trading day. This daily accounting which includes the determination of contract settlement prices and margin adjustments to reflect gains and losses is called "marking-to-market."

Marking-to-market requires daily cash adjustments through the exchange clearing association to reconcile exchange members' net gains and losses on their positions. At the close of trading each day, every member must mark all customer accounts to the settlement prices (current market value) for the day. Gains and losses are immediately deposited into or withdrawn from the customer accounts. Customers in turn are entitled to withdraw their gains, or are required to deposit any margin required because of losses in their accounts, at the close of every day under this marking-to-market system.

The Act adopts a marking-to-market system for the taxation of commodity futures contracts. This rule applies the doctrine of constructive receipt to gains in a futures trading account at year-end. The application of this rule elsewhere in the tax law generally means, for example, that taxpayers must include in their income any interest which has accrued in their savings account during the year, even though they may not have withdrawn the interest. Because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, the Congress believed it appropriate to measure the taxpayer's futures' income on the same basis for tax purposes.

Explanation of Provision

General rule

Under the Act, gain and loss from all regulated commodity futures contracts must be reported on an annual basis under a mark-to-market rule. This tax rule corresponds to the daily cash settlement, mark-to-market system employed by commodity futures exchanges in the United States for determining margin requirements. Straddles which are composed solely of futures contracts and which are not part of a larger straddle are subject to the new mark-to-market rules and are excepted from the loss deferral rule (new sec. 1092), the regulations authorized to adapt wash-sale and short-sale principles and apply them to straddle positions, and the capitalization rule (sec. 263(g)).

All futures contracts must be marked-to-market at year end. Each regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. Ordinarily, the settlement prices determined by an exchange for its futures contracts on the year's last business day are to be considered the contract's fair market

value. Any gain or loss on the contract is taken into account for the taxable year, together with the gain or loss on other futures contracts which were held during the year but closed out before the last business day. Thus, taxpayers' net gain or loss is approximately equal to the aggregate net amount which is credited to their margin accounts as variation margin, or which they had to pay into their accounts as variation margin, during the year.

If a taxpayer holds futures contracts at the beginning of a taxable year, any gain or loss subsequently realized on these contracts must be adjusted to reflect any gain or loss taken into account with respect to these contracts in a prior year.

Any capital gain or capital loss on a regulated futures contract which is marked-to-market is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent of the gain or loss is long-term capital gain or loss. For 1982 and later years, this allocation of capital gain between short-term and long-term results in a top rate of tax of 32 percent on such gains. Regulated futures contracts continue to constitute capital assets in all cases in which they would have constituted capital assets under prior law. Treatment of gains and losses as partially short-term and partially long-term is not intended to affect the character of such contracts as capital assets nor to eliminate the holding period requirements applicable to assets which are not regulated futures contracts. Any ordinary income or loss items on the mark-to-market system continue to be taxed at the regular tax rates applicable to such income. Thus, for example, gain or loss on a postion not identified as a hedging transaction under section 1256(e) that is treated as an ordinary income asset under the rule of the *Corn Products* decision will constitute ordinary income or loss and is not subject to the 60/40 rule.

Adaptation of the mark-to-market system to the determination of taxable gain or loss from regulated futures contracts requires that the marked-to-market settlement price of every position held at any time during the taxable year be determined on each relevant date as necessary to include in taxable income all regulated futures contract gains and losses from such positions. Accordingly, the mark-to-market rules, including the allocation between long-term and short-term capital gain or loss, apply to any termination of a taxpayer's obligation with respect to a regulated futures contract whether the termination is executed by offsetting, by taking or making delivery, by transfer of the taxpayer's interest in the contract, or in some other manner. These mark-to-market rules apply to a transfer notwithstanding that nonrecognition of gain or loss would result from the application of any other provision of the Code. Gain or loss upon termination is determined on the basis of the contract's fair market value at the time of termination, ordinarily the actual price received or paid if the termination is a closing transaction.

Regulated futures contracts

Unless specifically excepted, all regulated futures contracts are subject to the mark-to-market rules.

A regulated futures contract means a contract (1) which requires delivery of personal property or an interest in personal property,

as defined in new section 1092(d)(1); (2) which is marked-to-market under a daily cash flow system of the type used by United States commodity futures exchanges to determine the amount which must be deposited, in case of losses, or the amount which may be withdrawn, in the case of gains, as a result of price changes with respect to the contract during the day; and (3) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or of any board of trade or exchange which the Treasury determines operates under rules adequate to carry out the purposes of the mark-to-market provisions.

Mixed straddles

The Act provides special rules for the taxation of straddles composed of at least one position in regulated futures contracts and one or more positions in interests in property which are not regulated futures contracts. If the taxpayer clearly identifies each position in such a straddle as belonging to the straddle by the close of the day of the position's acquisition, the straddle herein is called an identified mixed straddle.[1]

The taxpayer may elect to exclude all positions in regulated futures contracts which belong to an identified mixed straddle from the mark-to-market rules; in that case, they will be subject to the loss deferral, wash sale, and short sale rules. The taxpayer's election is permanent and may be changed only with the consent of the Treasury. If a regulated futures contract is taken off the mark-to-market system pursuant to an election, it may not subsequently be switched back onto it. A taxpayer may not elect to bring any positions that are not regulated futures contracts onto the mark-to-market rules.

If a taxpayer fails to identify the positions constituting a mixed straddle, or if a taxpayer does not elect to remove futures positions in an identified mixed straddle from the mark-to-market rules, the amount of any gain or loss on futures contracts in the straddle is determined under the mark-to-market rules. Gain or loss on other positions in the straddle is determined under the regular tax rules. All positions in the straddle, both futures contracts and other property, are subject to the loss deferral and other rules in section 1092, and the capitalization rule in section 263(g). The application of section 1092 to such unidentified mixed straddles will result in the deferral of all losses with respect to which there is offsetting unrealized gain. However, gain taken into account under the mark-to-market rules is not treated as unrealized and will not defer the deduction of losses. Therefore, losses sustained in excess of offsetting unrealized gain, if any, on positions that are not regulated futures contracts in such a straddle will not be deferred because of gains marked-to-market on the offsetting regulated futures contracts. Conversely, losses otherwise allowable on the regulated futures contracts on the mark-to-market system will be deferred to the extent of unrealized gain on the offsetting positions that are not regulated futures contracts.

[1] New sec. 1256 (d) (4) uses the term "mixed straddle" to describe what is here termed an "identified mixed straddle."

Hedging exemption

The mark-to-market rules do not apply to hedging transactions. For purposes of the mark-to-market rules, a hedging transaction means a transaction which the taxpayer executes in the normal course of his or her trade or business primarily to reduce certain risks, which results in only ordinary income or ordinary loss and which is properly identified by the taxpayer as a hedging transaction. Hedging transactions are varied and complex. They may be executed in a wide range of property and forms, including options, futures, forwards, and other contract rights and short sales.

A hedging transaction may be executed to reduce the risk of price change or of currency fluctuations with respect to property which is held or to be held by the taxpayer and which, if disposed of at a gain, whether by sale, exchange, lapse, cancellation, or otherwise, produces ordinary income. Also, a hedging transaction may be executed to reduce the risk of price or interest rate changes, or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, provided all income or gain on such borrowings or obligations is treated as ordinary income. Gain or loss on dispositions both of the hedged property and of the hedge itself must be ordinary.

Transactions which result in capital gains or capital losses do not qualify for the hedging exemption. Speculation in commodity futures contracts, for example, does not qualify for this exemption whether a trader takes outright long or short positions, or whether a trader speculates in spreads, because futures speculation always produces only capital gains or capital losses.

Special rule for banks

The Act provides a special definition of "hedging transactions" for banks (as defined in section 581). For a transaction conducted by a bank to qualify as a hedging transaction, it must be entered into by the bank in the normal course of the bank's trade or business, the gain or loss on the transaction must be treated as ordinary income or loss, and it must be properly identified by the bank as a hedging transaction. The bank's transactions need not fulfill the primary purpose requirements of clauses (i) and (ii) of section 1256(e)(2)A, which specify certain types of risk reducing activities with respect to price, interest rate, and currency fluctuations. This special rule is intended to allow certain business activities which are conducted regularly by banks, but which may not be conducted primarily for risk reduction (for example, foreign currency trading), to qualify for the hedging exemption.

Identification requirements

For a transaction which constitutes one of the activities treated as hedging under section 1256 and which generates ordinary income or loss under normal tax principles to qualify as a hedging transaction under the definition in section 1256(e)(2), the transaction also must be clearly identified in the taxpayer's records as being part of a hedging transaction before the close of the day on which the taxpayer entered the transaction.

Regulations should allow taxpayers to minimize bookkeeping identification requirements in as many cases as practicable. In situations where hedging transactions are numerous and complex, but opportunities for manipulation of transactions to obtain deferral or conversion of income are minimal, it generally is unnecessary to require taxpayers to keep records which identify and match particular hedging transactions with particular hedged properties.

In certain hedging transactions (for example, those conducted by banks), it may be extremely difficult to match a hedging contract with a specific hedged property. In such cases, it may be sufficient for this identification requirement to mark an entire account, such as the bank's securities trading account, as a hedged account. If the bank's securities trading account, which produces only ordinary income or loss, is managed and recorded independently and separately from the bank's investment account (and any other capital asset account), there is little danger of manipulation for conversion. Moreover, because Federal regulatory agencies impose certain standard accounting practices on banks, their deferral opportunities too are limited. Thus, detailed identification or matching of such hedging activities ordinarily would serve no useful purpose.

However, in cases where taxpayers do not maintain and manage their ordinary income transactions separately from their capital transactions and where other factors indicate a danger of manipulation, more detailed identification records may be required.

If personal property (as defined in section 1092(d)(1)) has ever been identified by the taxpayer as being part of a hedging transaction, gain from the sale or exchange of the property may never be treated as capital gain but must be reported as ordinary income. The term personal property, as defined in section 1092(d)(1), covers any personal property of a type which is actively traded, but specifically excludes stock. Thus, if a taxpayer holding a stock position and a balancing position (say, in forward contracts) identified the positions as a hedging transaction, this rule would not apply. Any gain on the stock (or forwards) would not become ordinary, if it otherwise would be capital. The taxpayer's positions would not constitute a straddle, because the positions, though they may be offsetting, are not both positions in personal property.

In no event is the provision of this hedging exemption to be interpreted as precluding the Commissioner of Internal Revenue from exercising his present law authority to require that taxpayers employ accounting methods which clearly reflect their income.

Prior law rules characterizing as ordinary the gain or loss on transactions constituting an integral part of a taxpayer's trade or business continue to apply so that ordinary income or loss may result from transactions that are not within the hedging exemption.

Syndicate rule

In order to prevent possible manipulation of the hedging exemption by tax shelters structured as limited partnerships, the exemption for hedging transactions does not apply to transactions entered into by syndicates. Thus, unless excluded as mixed straddles, a syndicate's transactions in futures contracts are taxed under the mark-to-market rules. A syndicate's transactions in mixed strad-

dles, whose futures positions are taken off the mark-to-market system, as well as straddles in other property are subject to the loss deferral rule in section 1092, the modifications of the wash sale and short sale rules, and the capitalization rule in section 263(g).

A syndicate means any partnership or other entity (other than a corporation that is not a subchapter S corporation), if more than 35 percent of the entity's losses during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of sec. 464(e)(2)).

Certain interests not counted

The Act provides that in five situations, certain interests held by limited partners or by limited entrepreneurs (within the meaning of sec. 464(e)(2)), are not to be treated as limited or passive interests counted in applying the test for 35 percent of losses in determining whether an entity is a syndicate.

First, an interest is not to be treated as held by a limited partner or limited entrepreneur for any period if during the period the interest is held by an individual who actively participates at all times during the period in the management of the entity.

Similarly, second, an interest held by the spouse, children, grandchildren, or parents of an individual who actively participates in the management of the entity will not be treated as a limited or passive interest. A legally adopted child is to be treated as a child by blood.

Third, an interest held by an individual who actively participated in the management of the entity for at least 5 years is not to be treated as a limited interest.

Fourth, an interest held by the estate of an individual who actively participated in the management of an entity for at least five years, as well as interests held by the estate of the spouse, children, grandchildren or parents of such an individual, are not to be treated as limited interests.

Fifth, the Act delegates to the Treasury the authority to determine whether certain other interests should be treated as active interests. The Treasury may allow an interest to be treated as an active interest if it determines that an interest should be treated as held by an individual who actively participates in the management of the entity and that neither the entity nor the interest are used (or will be used) for tax-avoidance purposes.

Elections

General rule

The Act provides that the mark-to-market rules apply to property acquired and positions established by the taxpayer after June 23, 1981, in taxable years ending after that date. However, the mark-to-market rules may be applied to futures contracts held on or before that date under either of two elections provided by the Act.

Under section 508(c) of the Act, taxpayers may elect the new rules governing the taxation of straddles, including the mark-to-market rules, for positions which they held on June 23, 1981, for periods after that date. The election must cover all positions held by the taxpayer on that date.

Taxpayers holding regulated futures contracts may avail themselves of an alternative election with respect to such contracts under section 509 of the Act for the taxable year which includes June 23, 1981.

Futures held on June 23, 1981

A taxpayer who held regulated futures contracts on June 23, 1981, may elect under section 508(c) of the Act to apply the mark-to-market rules to all regulated futures contracts held on that date, regardless of the date of their acquisition. If this election is made, gain or loss on all futures held on June 23, 1981 (and later in the taxable year which includes June 23, 1981) would be taxed under the mark-to-market rules. Any gain or loss on futures contracts disposed of before June 23, 1981, would be unaffected by the election. Such gain or loss would be measured at the time of the contracts' dispositions and would be treated as long-term or short-term, according to the actual holding period for the contract.

If the election under section 508(c) is made, any gains on regulated futures contracts held on June 23, 1981, would be 60 percent long-term taxed at a maximum rate of 20 percent in 1981 and later years. 40 percent of such gains subject to short-term treatment would be taxed at a maximum rate of 70 percent in 1981 and 50 percent in later years.

Gains and losses on regulated futures contracts disposed of before June 23, 1981 (if the sec. 508(c) election is made), and at any time for futures positions created on or before June 23 if no election is made, are taxed at the rates applicable to the disposition of capital assets other than regulated futures contracts. Thus, long-term gains on futures contracts held by individual speculators would be taxed at a maximum rate of 28 percent, if liquidated on or before June 9, 1981, and at a maximum rate of 20 percent if disposed of after June 9, 1981. The top marginal tax rate on short-term gains on contracts which were liquidated during 1981 would be 70 percent and 50 percent for contracts liquidated in later years. Any election under section 508(c) of the Act must apply both to futures positions and positions in property other than futures held on June 23, 1981. Thus, an electing taxpayer must apply the provisions of new code section 1092 to all straddles other than straddles wholly in regulated futures contracts, if such positions were held on June 23, 1981.

Five-year payment

General rule.—In lieu of any election under section 508(c) of the Act, a taxpayer may elect under section 509 to have the mark-to-market rules apply to all regulated futures contracts held by the taxpayer during the taxable year which includes June 23, 1981. If a taxpayer makes this full year election under section 509 of the Act, all regulated futures contracts held by the taxpayer at any time during the taxable year must be marked-to-market; net gains on such contracts will be taxed at the rates applicable to taxable years beginning in 1982 determined as the difference between tax liability without regard to credits computed at 1982 rates on 1981 taxable income including net gains on regulated futures contracts and on 1981 taxable income reduced by such net gains; and any tax liabili-

ty for 1981 which is attributable to appreciation which occurred in such contracts prior to the beginning of the taxable year may be paid in two to five equal annual installments. The first installment must be paid on or before the due date for filing the return for the taxable year which includes June 23, 1981. For calendar year taxpayers, the first installment would be due on April 15, 1982. Subsequent installments would become due with interest annually thereafter.

Amount payable in installments.—Under the Act, the maximum amount of tax which may be paid in installments pursuant to the section 509 election is computed by determining the tax liability for the year, calculated under section 509(a)(2) by applying the mark-to-market rules and special rate to all futures contracts held during the year, and reducing that liability under section 509(a)(3)(B)(ii) by the amount of tax which would be due, if only the gains and losses actually attributable to changes in the contracts' value during the taxable year were taken into account. The amount of gain (or loss) attributable to the taxable year which includes June 23, 1981, is determined by treating all regulated futures contracts which were held by the taxpayer on the first day of the taxable year and which were acquired by the taxpayer prior to that day, as if the contracts were purchased or entered into for their fair market value (generally their settlement price) on the last business day of the preceding taxable year.

Date for installment payment.—Taxpayers who elect full-year mark-to-market treatment for their 1981 taxable year and choose to make installment payments under section 509 of the Act must pay the first installment of the tax with respect to gains rolled into 1981 from prior years on or before the due date for filing their 1981 tax return. For calendar year taxpayers, the first installment would be due on April 15, 1982. Succeeding installments, plus interest on these outstanding liabilities computed at the statutory rate, would be due on or before April 15 annually thereafter.

The Act protects the Treasury's right to recover these liabilities in the event that a taxpayer becomes bankrupt. If any bankruptcy case or insolvency proceeding involving the taxpayer begins before the final installment is paid, the total amount of any unpaid installments is treated as due and payable on the day preceding the commencement date of such case or proceedings.

Interest.—Interest is charged on any unpaid installments of tax which are attributable to gains rolled forward from prior years into 1981 and which are still outstanding after the due date for the first installment. Thus, calendar year taxpayers would be liable for interest on installments unpaid after April 15, 1982. Interest would be computed at the statutory rate prescribed for underpayments by section 6601.

Form of election.—An election under section 509 of the Act must be made no later than the time prescribed for filing the tax return for the 1981 taxable year affected by the election and must be made in the manner and form required by regulations prescribed by the Treasury.

In making the election, the taxpayer must report the amount of tax liability determined to be attributable to appreciation in prior years and the number of installments to be paid. The taxpayer also

must report each regulated futures contract held on the first day of the 1981 taxable year and the date of acquisition of each of these regulated futures contracts, whether or not the contract was acquired on the first day of the 1981 taxable year or prior to that date. The election also must set forth the settlement price for each reported regulated futures contract for the last business day of the preceding taxable year. The election must contain any additional information required by regulations for carrying out these provisions.

Effective Date

The changes made by the provision generally apply to property acquired and positions established by taxpayers after June 23, 1981, in taxable years ending after such date.

The identification requirement for hedging transactions in section 1256(e)(2)(C) applies to property acquired by taxpayers after December 31, 1981, in taxable years ending after that date.

4. Carryback of losses from regulated futures contracts to offset prior gains from such contracts (sec. 504 of the Act and sec. 1212 of the Code)

Prior Law

Under prior law, taxpayers could carry ordinary losses which are net operating losses back to each of the three taxable years preceding the taxable year in which such losses were sustained and forward to each of the seven subsequent taxable years.[1] Corporations generally could carry capital losses back to the three preceding taxable years and forward to the five subsequent taxable years. Individual taxpayers could carry capital losses forward, but prior to the Act could not carry any capital losses back to prior years.

Individual taxpayers with significant increases in income could qualify to average their income over a five-year period which includes the four preceding taxable years (secs. 1301–1305). However, significant decreases in income do not entitle taxpayers to benefit from the provisions for income averaging.

Reasons for Change

Investors in commodity futures contracts bear substantial risks and sometimes incur very significant losses because of the volatility of many futures markets. The Congress recognized the significance of these risks, and the unique nature of futures contracts which are marked-to-market daily for both trading and tax purposes, even though an investor may continue to hold the same position. The Congress believed that the possible economic distortions in income tax liability which might result from these factors might not be adequately mitigated by capital loss carry forwards or the income averaging rules and should be alleviated; therefore, the Congress provided a three-year carryback for losses on futures contracts taxed under the mark-to-market rules.

Explanation of Provision

Election to carry back losses

The Act permits an election under which net commodity futures capital losses may be carried back three years and applied against net commodities futures capital gains during such period.[2]

The carryback is available only if, after netting regulated futures contracts and other positions subject to the marked-to-market rule of section 1256 with capital gains and losses from other sources, there is a net capital loss for the taxable year which, but for the election, would be a capital loss in the succeeding year under section 1212(b). The lesser of such net capital loss or the net loss resulting from the application of the marked-to-market rule of

[1] This Act generally allows a 15-year carryforward of net operating losses.
[2] The carryback election is not available to an estate or trust.

section 1256(a) constitutes the "net commodity futures loss" which may be carried back.

The amount carried back may be applied only against net gains resulting from application of the marked-to-market rule of section 1256(a) in the carryback year. Such gains must be reduced by any net capital loss to which section 1256(a) did not apply in the carryback year, so that only to the extent the taxpayer had a net capital gain in the carryback year would any portion of the loss be allowed.

Treatment of carryback losses

Amounts carried back under the election are to be treated as if 40 percent of the losses are short-term capital losses and 60 percent are long-term capital losses. Such losses must be absorbed in the earliest year to which they may be carried back and any remaining amount is then carried forward to the next year in the same proportions of 40 and 60 percent. Losses are not allowable to the extent they would create or increase a net operating loss for the carryback year.

Amounts against which losses may be applied in the carryback year (i.e., "net commodities futures gain"), are determined without regard to "net commodity futures loss" for the loss year or any year thereafter. Because the marked-to-market system begins in 1981 and no taxpayer has net marked-to-market capital gains for a prior year, 1981 is the earliest year to which net commodity futures capital losses can be carried back.

Losses absorbed in carryback years under the election are treated as capital gains for the loss year in the 40-percent short-term and 60-percent long-term proportions for the purpose of determining the amount of any net capital loss to be carried forward to a succeeding year under section 1212(b)(1). If capital losses are carried forward under section 1212(b), to the extent they were determined under the marked-to-market rule of section 1256(a), they continue to be treated as losses from regulated futures contracts in the year to which they are carried.

Illustration

The capital loss carryback election for regulated futures contracts may be illustrated by the following example.

Assume that the taxpayer in 1985 has net losses of $100,000 from regulated futures contracts under the marked-to-market rule of section 1256(a). In addition, the taxpayer has a $3,000 short-term capital loss and $50,000 long-term capital gain. Under section 1211, the taxpayer's capital losses are applied against the $50,000 of long-term capital gain and $3,000 of other income, leaving a $50,000 loss. If the carryback election under section 1212(c) is not made, the $50,000 loss may be carried to 1986 under section 1212(b). Initially, the $100,000 net loss from regulated futures contracts is treated as $40,000 of short-term loss and $60,000 of long-term loss under the marked-to-market rule. Since the taxpayer has $50,000 of long-term gain from other sources, only $10,000 of long-term loss remains, which, along with the $40,000 short-term loss, is carried to 1986 and treated as losses from regulated futures contracts in that year.

If the taxpayer makes the section 1212(c) election, net losses from regulated futures contracts are carried back to 1982 but only to the extent of the net capital loss which would otherwise become a capital loss in 1986 under section 1212(b), i.e., $50,000. The amount carried back is treated as 40-percent short-term loss and 60-percent long-term loss in the carryback year. Thus, the $50,000 carried back will be treated as $20,000 of short-term loss and $30,000 of long-term loss from regulated futures contracts in 1982. The amount carried back may be applied only against gains from regulated futures contracts in the carryback year and only to the extent the taxpayer had a net capital gain in such year.

Assume that the taxpayer in 1982 had a net gain of $50,000 from regulated futures contracts and a long-term capital loss from other sources of $30,000. The gains subject to section 1256 were $20,000 short-term, and $30,000 long-term which was absorbed by the $30,000 of unrelated long-term loss, leaving a net short-term gain of $20,000 to be offset by $20,000 of the $50,000 loss carried back from 1985. If the taxpayer has no net gains or losses from regulated futures contracts in 1983 or 1984, the $30,000 of unused losses would be carried forward to 1986 under section 1212(b) and would be treated as losses from regulated futures contracts in that year.

For purposes of determining the capital losses which may be carried forward under section 1212(b), any losses from regulated futures contracts absorbed as carryback losses under the new rules are treated as capital gains in the 40-percent short-term, 60-percent long-term ratios in the loss year. Thus, assume that a taxpayer has $50,000 of losses from regulated futures contracts in 1985 and a $50,000 long-term capital loss from other sources plus an additional $3,000 short-term loss absorbed against other income under sec. 1211. If $20,000 of the losses from futures contracts were absorbed as carryback losses as illustrated above, $80,000 of losses would remain to be carried forward to 1986 under section 1212(b), $68,000 of which would be long-term and $12,000 would be short-term. Of the long-term loss, $18,000 would be treated as a loss from regulated futures contracts in 1986 and all of the short-term loss would be so treated. This result is obtained by treating the $20,000 absorbed as carryback losses as though the taxpayer had gains in that amount from regulated futures contracts in 1985, leaving $18,000 and $12,000 of long-term and short-term losses, respectively, to be carried forward as regulated futures losses to 1986 and leaving the $50,000 long-term loss from other sources to be carried forward to 1986 unaffected by the carryback.

Effective Date

The provision applies to property acquired and positions established by taxpayers after June 23, 1981, in taxable years ending after that date. Losses may be carried back to taxable years no earlier than taxable years ending in 1981.

5. Certain governmental obligations issued at discount treated as capital assets (sec. 505 of the Act and secs. 1221 and 1232 of the Code)

Prior Law

Most assets held for investment are treated as capital assets. Net long-term gain from the sale or exchange of these assets results in favorable tax treatment, and any deductions for net losses from sales or exchanges of capital assets are limited (see discussion of capital gains under the prior law discussion of straddles, above.) Recognized loss not treated as loss from the disposition of capital assets is treated as ordinary and is not subject to the capital loss limitations.

Prior to the Act, certain governmental obligations (Treasury bills) issued on a discount basis payable without interest at a fixed maturity not exceeding one year from the date of issue were treated as ordinary income property instead of as capital assets (sec. 1221(5)). This provision was originally added to the Code in 1941, to relieve taxpayers of the requirement of separating the interest element from the short-term capital gain or loss element when an obligation is sold before maturity.[1] Thus, all gains or losses from transactions in such obligations were treated as ordinary income or ordinary loss at the time the obligation was paid at maturity, sold, or otherwise disposed of (sec. 454(b)).

In Revenue Ruling 78-414,[2] the Internal Revenue Service held that a futures contract to purchase Treasury bills is a capital asset if held for investment. Thus, for tax-avoidance purposes, some taxpayers holding offsetting positions in Treasury bill futures took delivery of the Treasury bills on the loss leg of the straddle and sold the bills themselves in order to convert the short-term capital loss on the futures contract into a fully-deductible ordinary loss on the bills.

Reasons for Change

Because of the ordinary income character of Treasury bills, these obligations had been used together with capital assets in the design of tax shelters to convert ordinary income to capital gains. In combination with other bonds, all of which are capital assets, and with futures contracts for Treasury bills, straddles had been structured which were intended to result in significant tax-savings. Tax shelter straddles in Treasury bill futures were causing significant losses in tax revenues.

Tax straddles in Treasury bill futures were touted as offering features unavailable in other futures straddles. These shelters were used in attempts to convert ordinary income (including, for example, salary, wages, interest, and dividends) into long-term capital

[1] S. Rep. 673 (77th Cong.), Part I, p. 30.
[2] 1978-2 C.B.213.

gain. This tax shelter opportunity was thought to occur because, under statutory rule, gain or loss on the sale of Treasury bills was considered ordinary income or loss, while, under the Revenue Service interpretation, gain or loss on the sale of Treasury-bill futures contracts was considered capital gain or loss.

Straddles in Treasury bill futures generally were structured in the same way as other futures straddles; i.e., contracts to buy Treasury bills were offset by an equivalent number of contracts to sell Treasury bills. The execution of these "T-bill" shelters involved one difference. In the case of a loss on a long leg, when the delivery month arrived, the taxpayer took delivery of the bills and then disposed of the bills themselves creating an ordinary loss; in the case of a loss on a short leg, the taxpayer purchased the bills at the market price and delivered the bills themselves at the contract's lower price creating an ordinary loss. Ordinary losses are fully deductible against any type of ordinary income. The gain leg of the straddle would be terminated by disposing of the futures contract through a transaction on the exchange and the taxpayer would claim capital gain treatment, normally short-term. If necessary to achieve the desired tax saving, the taxpayer could then enter into a new straddle not involving T-bills to generate a year-end capital loss to preclude current taxation of the gain from the T-bill future and hopefully to convert it into long-term gain in the following year by having gain occur on the long position of his new straddle.

The Congress was concerned about the adverse impact of Treasury bill straddles on Government tax revenues. Moreover, the number of contract holders demanding performance on Treasury bill futures contracts at the end of some years had threatened to exceed the supply of deliverable bills. This delivery problem could disrupt Treasury bill markets and damage Government financing generally. Therefore, the Congress believed that Government revenue and finance considerations required that these shelter activities be discouraged and that Treasury bills be characterized as capital assets. This change, coupled with a rule to facilitate the determination of discount income, would protect both Government revenues and debt management.

Because securities dealers' inventories are ordinary income or loss accounts, without regard to sec. 1221(5), this change does not affect their operations. The computation of discount income would entail only a minor increase in taxpayers' paperwork. The Congress adopted the new rule as the simplest and most correct method of measuring such income.

Explanation of Provision

The Act provides that obligations of the United States, of its possessions, of a State or political subdivision of a State, or of the District of Columbia, issued on a discount basis and payable without interest in less than one year, are treated as capital assets in determining gain or loss.

In order to facilitate the determination of discount applicable to any holder, the Act adds a new paragraph (4) to section 1232(a), treating as ordinary income the gain from the disposition of such short-term government obligations to the extent of the ratable share of "acquisition discount" received by the taxpayer. The rat-

able share is the portion equal to the ratio of the number of days the obligation is held by the taxpayer to the number of days between the date of acquisition by the taxpayer and the date of maturity. Acquisition discount is the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation. For purposes of this provision, stated redemption price at maturity includes any interest payable at maturity. This provision does not apply to obligations with respect to which interest is not includible in income under section 103.

This formulation will enable each holder to determine the portion of any proceeds from disposition of such an obligation to be treated as ordinary discount income without reference to original issue discount or the treatment applicable to any other holder. Any gain exceeding the taxpayer's ratable share of acquisition discount is short-term capital gain and any loss on disposition of an obligation is short-term capital loss.

Effective Date

The provision applies to property acquired and positions established by taxpayers after June 23, 1981.

6. Prompt identification of securities by dealers in securities (sec. 506 of the Act and sec. 1236 of the Code)

Prior Law

Under prior and present law, gains and losses from property held primarily for sale to customers in the ordinary course of business are taxed as ordinary gains or losses. Gains and losses from property held for investment are taxed as capital gains and losses.

Gains and losses from the sale of property of a type held by a person primarily for sale are generally ordinary. However, the prior law contained a rule (sec. 1236) to allow a securities dealer to identify and segregate certain of its assets as held for investment.

In order to receive capital gains treatment, a security held by a dealer had to be "clearly identified" on the dealer's records as held for investment within 30 days following the date of acquisition and became ineligible for such treatment if it was thereafter held primarily for sale to customers. If a security was at any time clearly identified as held for investment, ordinary loss treatment was denied. The term "security" means any share of corporate stock, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to, any of the above.

Reasons for Change

Because a dealer could wait 30 days to identify securities held for investment, the dealer might wait the 30 days to determine which securities increased in value. The dealer might choose to identify these appreciated securities as held for investment in the expectation that this appreciation would hold or continue and be eligible for preferential treatment as long-term capital gain upon disposition of the security. Also, the dealer might want to treat any securities which have declined in value as held primarily for sale to customers in order to treat losses from these securities as fully deductible ordinary losses.

Some taxpayers considered securities dealers' unique tax-planning opportunities so significant that they established themselves as broker-dealers solely to exploit these opportunities. Large broker-dealer partnerships passed these tax benefits through to hundreds of partners. Many of these broker-dealer partnerships sold shares in their operations for fees which were based on a percentage, usually ten percent, of the tax loss sought by the investor.

The Congress believed that requiring dealers to identify securities held for investment on their date of acquisition would end most abuse of the broker-dealer role. Because computers are used commonly now and because prudent investors, including dealers, know the purpose of their transactions when executed, delay in identification is unnecessary and unwise. In view of their special

responsibilities with respect to the stock for which they are registered, floor specialists are allowed seven business days to designate their specialist stock which is held for investment.

Explanation of Provision

The Act requires a dealer in securities to identify a security as held for investment not later than the close of business on the date of the security's acquisition. No security which is part of an offsetting position may be treated as clearly identified in the dealer's records as a security held for investment unless all securities belonging to the offsetting position are properly identified in a timely manner. The Act, while changing the identification requirement applicable to securities which the taxpayer treats as held for investment, does not otherwise change rules of prior law applicable in determining whether gain from the disposition of securities is capital gain.

A special rule is provided for floor specialists. A floor specialist on a national securities exchange is allowed seven business days after the date of acquisition of stock in which the specialist is registered with the exchange to identify such stock which is held for investment. This exception applies only with respect to acquisitions of stock in connection with the specialist's duties as a specialist in the stock on the exchange where the specialist is so registered. The Act defines a floor specialist as a person who is a member of a national securities exchange, is registered as a specialist with the exchange, and meets the requirements for specialists established by the Securities and Exchange Commission.

Effective Date

The provision applies to property acquired and positions established by taxpayers after December 31, 1981, in taxable years ending after that date. Property acquired or positions established by taxpayers after June 23, 1981, but before January 1, 1982, must be identified as held for investment by the close of business on the first day after the day the security was acquired.

7. Treatment of gain or loss from certain terminations (sec. 507 of the Act and new sec. 1234A of the Code)

Prior Law

The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions prior to the Act interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.[1] This interpretation applied even to dispositions which were economically equivalent to a sale or exchange of a capital asset.

Reasons for Change

The Congress believed that the change in the sale or exchange rule was necessary to prevent tax-avoidance transactions designed to create fully deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would have produced capital gains. These transactions already have caused significant losses to the Treasury.

Some taxpayers and tax shelter promoters attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222, which requires that there be a sale or exchange of a capital asset.

As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which were not considered sales or exchanges of the property, were reported as fully deductible ordinary losses instead of as capital losses, whose deductibility was restricted. However, if such property increased in value, the taxpayer sold or exchanged it so that capital gains were reported as long-term gains when the holding period requirements were met.

Some of the more common of these tax-oriented ordinary loss and capital gain transactions involved cancellations of forward contracts for foreign currency or for securities.

The Congress considered this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, was economically equivalent to a sale or exchange of the contract. For example, a taxpayer might have simultaneously entered into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declined, the taxpayer sold his contract to sell marks to a bank or other institu-

[1] See *Teh* v. *Comm'r*, 260 F. 2d 489 (9th Cir., 1952), and *Comm'r* v. *Pittston Co.*, 252 F. 2d 344 (2d Cir.), cert. denied, 357 U.S. 919 (1958).

tion for a gain equivalent to the excess of the contract price over the lower market price and cancelled his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer treated the sale proceeds as capital gain but treated the amount paid to terminate his obligation to buy as an ordinary loss.

Explanation of Provision

In order to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment, the Act adds a new section 1234A to the Code providing that gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property shall be treated as gains or losses from the sale of a capital asset. Property subject to this rule is any personal property (other than stock) of a type which is actively traded (sec. 1092(d)(1)) and which is, or would be on acquisition, a capital asset in the hands of the taxpayer.

Effective Date

The provision applies to property acquired and positions established by taxpayers after June 23, 1981.

8. Revenue Effect

The provisions of Title V of the Act, relating to tax straddles, are estimated to increase fiscal year budget receipts by $37 million in 1981, $623 million in 1982, $327 million in 1983, $273 million in 1984, $249 million in 1985, and $229 million in 1986.

These estimated revenue effects do not reflect transactions entered into after December 31, 1981. The total revenue effects for later years might be affected by judicial decisions relating to the tax treatment of straddle transactions under prior law.

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TITLE VI.—ENERGY PROVISIONS

A. Changes in Windfall Profit Tax

1. Royalty owners credit and exemptions (sec. 601 of the Act and secs. 4991, 4994, 4995, 6429, 6654, and 6655 of the Code)*

Prior Law

The Crude Oil Windfall Profit Tax Act of 1980 imposed an excise tax on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification in one of three tiers; lower rates apply on up to 1,000 barrels a day of tier one and tier two oil produced by independent producers. Royalty owners, and owners of similar nonoperating mineral interests, are not independent producers eligible for lower rates.

Prior law provided qualified royalty owners with a credit (or refund) of up to $1,000 against the windfall profit tax imposed on the removal of their royalty oil during calendar year 1980. The credit was available only to individuals, estates, and qualified family farm corporations. It could be claimed in 1981, in accordance with Treasury regulations, either on the royalty owner's income tax return or in a separate refund claim.

Reasons for Change

The Congress believed that imposition of the windfall profit tax on small amounts of royalty oil income imposed a hardship on many low- and middle-income taxpayers. These individuals were not recipients of the large oil company profits which led, in part, to enactment of the windfall profit tax. The Congress concluded that a one-year extension of the credit (together with an increase in the credit to $2,500), followed by a limited exemption, was needed to assure that small royalty owners are not adversely affected by the tax.

Explanation of Provision

Extension, increase of credit

The Act makes the royalty owners credit available for calendar year 1981, and increases the maximum credit from $1,000 to $2,500 for royalty oil production removed from the premises in 1981. Technical amendments to sections 6654 and 6655 permit the Treasury Department to avoid imposing penalties on persons whose estimated taxes were underpaid because of the manner in which the royalty credit interacts with the income tax.

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*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 241; S. Rep. No. 97-144 (July 6, 1981), pp. 93-95; H.R. 4242, as reported by the House Ways and Means Committee, sec. 602; H. Rep. No. 97-201 (July 24, 1981), pp. 217-218; H.R. 4242, as passed by the House (July 29, 1981), sec. 601; and H. Rep. No. 97-215 (August 1, 1981), p. 228 (Joint Explanatory Statement of the Committee of Conference).

Exemption

For 1982 and subsequent years, the Act provides a limited exemption from the windfall profit tax for specified amounts of royalty production.

In 1982 through 1984, royalty owners will be exempt from tax on two barrels per day of qualified royalty production. In 1985 and thereafter, three barrels a day of production will be eligible for the royalty owner exemption. The Act also provides that the royalty owner may designate which barrels of qualified production will be exempt under the provision.

The Act also provides that the Treasury is to issue such regulations as may be necessary to permit royalty owners to reflect the exemption by reducing the withholding of windfall profit tax on qualified royalty owner production.

Special rules

To prevent a proliferation of royalty interests eligible for the credit and exemption, the Act retains, for purposes of the exemption, the allocation and related party rules applicable to the $1,000 credit (with the appropriate conforming modifications). In addition, the credit or exemption will not apply to production from an interest in proven property transferred after June 9, 1981, in a transfer described in the rules relating to eligibility for percentage depletion (sec. 613A(c)(9)(A)).

This transfer rule applies to all tiers of oil, and without regard to the methods of its production. However, the transfer rule does not apply to transfers between persons required to share a single $2,500 credit or a single exempt amount if production from the property interest transferred was qualified royalty production in the hands of the transferor. There also is an exception to the transfer rule for transfers that would not result in loss of percentage depletion because of the exceptions contained in the depletion rules for transfers at death or among related persons (sec. 613A(c)(9)(B)).

Similarly, the credit and exemption are not available for production from an overriding royalty, net profits interest, production payment, or similar interest created out of an interest in a proven property after June 9, 1981. This rule will prevent the creation of new royalty interests out of existing working interests in proven properties. An exception is provided for interests created under binding contracts entered into before June 10, 1981. The rule does not affect the ability of a landowner to retain a royalty on the lease of a proven property.

The Act modifies the definition of a qualified family farm corporation to provide that the family ownership and asset usage tests of prior law must be satisfied at all times during the calendar year in question. The Act eliminates the requirements that a qualified family farm corporation must have been in existence on June 25, 1980, and must have satisfied the asset usage test on that date.

Effective Date

The royalty owners credit provided by the Act applies to oil produced in calendar year 1981. The royalty owners exemption

applies to oil removed after December 31, 1981. The amendments relating to estimated tax penalties are effective on January 1, 1980.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $1,220 million in 1982, $947 million in 1983, $986 million in 1984, $1,193 million in 1985, and $1,279 million in 1986.

2. Reduction of windfall profit tax on newly discovered oil (sec. 602 of the Act and sec. 4987 of the Code)*

Prior Law

Under the Crude Oil Windfall Profit Tax Act of 1980, each barrel of newly discovered oil was subject to a tax equal to 30 percent of the windfall profit, i.e., the difference between the oil's actual selling price and the sum of its adjusted base price and the severance tax adjustment. The base price for newly discovered oil essentially is based on a $16.55 a barrel average removal price, adjusted for grade, quality, and location, and also adjusted quarterly for post-June 1979 increases in the GNP implicit price deflator plus two percent.

Reasons for Change

The Congress believed that reducing the windfall profit tax on newly discovered oil will increase significantly the incentive for exploration for, and development of, new oil prospects. This added incentive was expected to result in a significant increase in new oil production, and thus in a lessening of U.S. dependence on foreign oil.

Explanation of Provision

The Act provides for a gradual reduction of the windfall profit tax rate applicable to newly discovered oil, from the 30 percent rate applicable in 1981 to a rate of 15 percent in 1986 and later years. Specifically, the tax rates will be as shown in the following table:

	Percent
For taxable periods beginning in:	
1982	27.5
1983	25
1984	22.5
1985	20
1986 and thereafter	15

The definition of newly discovered oil is the same as that in prior law.

*For legislative background of the provision, see: H.J. Res. 266, as reported by the Senate Finance Committee, sec. 242; S. Rep. No. 97-144 (July 6, 1981), p. 96; Senate floor amendment, 127 Cong. Rec. S8182 (daily ed. July 22, 1981); H.R. 4242, as passed by the House (July 29, 1981), sec. 602; and H. Rep. No. 97-215 (August 1, 1981), p. 229 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision applies to taxable periods beginning after December 31, 1981. As a result, the first rate reduction will be for oil removed from the premises after December 31, 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $75 million in 1982, $255 million in 1983, $520 million in 1984, $867 million in 1985, and $1,528 million in 1986.

3. Exemption for stripper oil produced by independent producers (sec. 603 of the Act and secs. 4991, 4992, and 4994 of the Code)*

Prior Law

The Crude Oil Windfall Profit Tax Act of 1980 imposed an excise tax on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification in one of three tiers.

Tier 1 oil (previously controlled oil) generally is taxed at a 70-percent rate; tier 2 oil generally is taxed at a 60-percent rate. Lower rates of tax apply to up to 1,000 barrels a day of tier 1 and tier 2 oil production by independent producers. In the case of tier 2 stripper oil, this lower rate is 30 percent. Stripper oil is defined as oil from any property from which the average daily per well production has been ten barrels or less for any consecutive 12-month period after 1972. Tier 3 oil is newly discovered oil, heavy oil, and incremental tertiary oil. Under prior law, oil that was both tier 2 oil and tier 3 oil is treated as tier 3 oil.

Reasons for Change

The Congress believed that exemption of stripper properties owned by independent producers would prevent premature abandonment of such properties as the costs of production rise relative to the income available from the property.

Explanation of Provision

The Act exempts from the windfall profit tax, starting in 1983, stripper oil produced by independent producers. Stripper oil is defined as in prior law; however, oil which is both tier 3 oil and independent stripper oil eligible for the exemption is treated as exempt stripper oil and not as tier 3 oil.

The exemption applies only if the oil is produced from a working interest owned by an independent producer. Thus, the exemption does not apply to oil produced from royalty interests (including net profit interests and similar interests) or from interests owned by integrated producers. The definition of an independent producer is the same as that used for purposes of the lower windfall profit tax rates.

To prevent proliferation of interests eligible for exemption through the transfer of property, the Act provides that exempt stripper oil does not include any production from an interest in any

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 601; H. Rep. No. 97-201 (July 24, 1981), pp. 215-216; H.R. 4242, as passed by the House (July 29, 1981), sec. 603; and H. Rep. No. 97-215 (August 1, 1981), p. 228 (Joint Explanatory Statement of the Committee of Conference).

property that was owned, at any time after July 22, 1981, by a person other than an independent producer.

The Act also provides that a producer's independent producer amount eligible for lower rates is not reduced by any amount of oil exempt from tax under the new provision. Thus, for example, a producer could have more than 1,000 barrels a day of exempt stripper oil and claim lower rates on up to 1,000 barrels a day of tier 1 oil and tier 2 oil not eligible for the exemption.

Effective Date

The provision applies to oil produced and removed from the premises during calendar quarters beginning after December 31, 1982.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $525 million in 1983, $721 million in 1984, $762 million in 1985, and $797 million in 1986.

4. Exemption for certain child care organizations (sec. 604 of the Act and sec. 4994 of the Code)*

Prior Law

Oil production attributable to qualified interests of certain nonprofit educational organizations or medical facilities is exempt from the crude oil windfall profit tax. In addition, certain production from interests held on behalf of such organizations or facilities by a church is exempt. To qualify for the exemption, the charitable organization or facility must have owned the interests on January 21, 1980, and at all times thereafter.

Under prior law, an organization for the residential placement, care, or treatment of delinquent, dependent, orphaned, neglected, or handicapped children generally could not qualify for this exemption.

Reasons for Change

The Congress believed that the existing windfall profit tax exemption for certain nonprofit educational organizations and medical facilities should be expanded to include charitable residential child care organizations, since they furnish many of the same health care and educational services that are provided by hospitals and schools.

Explanation of Provision

The Act extends the windfall profit tax exemption for oil production attributable to economic interests held by specified educational organizations and medical facilities to oil production attributable to economic interests held by charitable organizations, described in section 170(c)(2), which are organized and operated primarily for the residential placement, care, or treatment of delinquent, dependent, orphaned, neglected, or handicapped children. To qualify for this exemption, the oil interest must have been held by the organization on January 21, 1980, and at all times thereafter before the last day of the calendar quarter.

If the interest is not held by the organization, the exemption still applies if the interest was held by a church for the benefit of the organization and if all the proceeds from the interest were dedicated on January 21, 1980, and at all times thereafter before the close of the calendar quarter, to the qualifying child care organization. These rules are the same as the prior rules relating to qualifying charitable interests.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7750-7752 (daily ed. July 16, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 606; H. Rep. No. 97-201 (July 24, 1981), pp. 221-222; H.R. 4242, as passed by the House (July 29, 1981), sec. 604; and H. Rep. No. 97-215 (August 1, 1981), p. 229 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision is effective for calendar quarters beginning after December 31, 1980.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $25 million in 1982, $15 million in 1983, $15 million in 1984, $15 million in 1985, and $15 million in 1986.

B. Miscellaneous Provision

Production credit for certain gases (sec. 611 of the Act and sec. 44D of the Code)*

Prior Law

An income tax credit is allowed for the production of specified alternative fuels, including several types of gas that are eligible for incentive pricing under the Natural Gas Policy Act of 1978 (NGPA).

The credit phases out as the price of uncontrolled domestic oil rises from $23.50 to $29.50 a barrel, adjusted for inflation after 1979. Because of this phaseout, the credit generally was not available during 1980.

Section 107(d) of the NGPA provides that gas production is not eligible for an incentive price if any special tax provision applies and if the producer does not file a price election with the Federal Energy Regulatory Commission (FERC) within 30 days of enactment of the special tax provision.

Reasons for Change

The Congress believed that gas producers should not be forced to affirmatively renounce a tax credit that was, in fact, not available to them in order to retain incentive pricing under the NGPA.

Explanation of Provision

The Act provides that no production credit is available unless the taxpayer elects it on the appropriate tax return. This has the effect of allowing the producer to elect the incentive prices under the NGPA after the 30-day period has elapsed.

The Act does not change any provision of the NGPA or deal with the FERC's administration of that Act. The Congress intended however, that the provision be administered by the Treasury Department and, to the extent appropriate, by FERC so as to prevent any producer from obtaining the benefits of both the production credit and the incentive price.

Effective Date

The provision applies to taxable years ending after December 31, 1979.

Revenue Effect

The provision does not have a revenue effect.

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8289-S8291 (daily ed. July 23, 1981); and H. Rep. No. 97-215 (August 1, 1981), p. 230 (Joint Explanatory Statement of the Committee of Conference).

TITLE VII.—ADMINISTRATIVE PROVISIONS

A. Prohibition of Disclosure of Audit Methods (Sec. 701 of the Act and sec. 6103(b) of the Code)*

Prior Law

Code section 6103 limits the disclosure of returns and return information.[1] In general, returns and return information are confidential and may be disclosed only as specifically provided in the Code. For purposes of section 6103, return information does not include data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.

Under prior law, questions arose as to whether the disclosure restrictions covered certain data derived by the Internal Revenue Service from its Taxpayer Compliance Measurement Program (TCMP).[2] TCMP data is employed by the Revenue Service in developing variables utilized to derive scores that are used for the purpose of ranking tax returns for audit selection purposes.

Reasons for Change

When the rules relating to disclosure of tax returns and return information were revised extensively in the Tax Reform Act of

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 702; H. Rep. No. 97-201 (July 24, 1981), pp. 238-239; H.R. 4242, as passed by the House (July 29, 1981), sec. 701; and H. Rep. No. 97-215 (August 1, 1981), p. 264 (Joint Explanatory Statement of the Committee of Conference).

[1] The term "return" is defined as any tax or information return, declaration of estimated tax, or claim for refund which is required (or permitted) to be filed on behalf of, or with respect to, any person. A return also includes any amendment, supplemental schedule, or attachment filed with the tax return, information return, etc.

"Return information" includes the following data pertaining to a taxpayer: the taxpayer's identity, the nature, source, or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, and tax payments. Also included in the definition of return information is any other data, received by, recorded by, prepared by, furnished to, or collected by the Revenue Service with respect to a return filed by the taxpayer or with respect to the determination of the existence, or possible existence, of liability for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense provided for under the Code. A summary of data contained in a return and information concerning whether a taxpayer's return was, is being, or will be examined or subject to other investigation or processing also is return information. However, under prior law, data in a form which could not be associated with, or otherwise identify, directly or indirectly, a particular taxpayer was not return information; apparently without regard to whether the data was TCMP data.

[2] In *Susan B. Long and Philip H. Long* v. *United States Internal Revenue Service*, 596 F.2d 362 (9th Cir. 1979), an action under the Freedom of Information Act (FOIA), the Ninth Circuit reversed a district court decision denying plaintiff-appellants access to this TCMP data from which the characteristics used to identify particular taxpayers had been deleted. The appellate court based its decision on section 6103(b)(2), which excluded from the definition of protected return information "data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer." That court remanded for consideration of whether, *inter alia*, the data, even with the identifiers deleted, might, nonetheless, be associated with particular taxpayers.

Additionally, in *Susan B. Long* v. *Bureau of Economic Analysis*, Civ. No. C78-176M (W. D. Wash., Dec. 31, 1980), aff'd, 646 F.2d 1310 (9th Cir. 1981), the plaintiff was granted access, on procedural grounds, to virtually the same data as was at issue in the earlier case. The Revenue Service did not release the TCMP data, pending further judicial action.

1976, the Congress did not intend to permit public disclosure of information that could seriously compromise the integrity of the Federal tax system. However, because substantial questions had arisen as to whether certain data used by the Internal Revenue Service to establish techniques for the selection of returns for audit might be subject to public disclosure, the Congress believed that it was desirable to further address that issue through explicit legislation.

The Congress determined that maintaining the confidentiality of that type of data outweighed any legitimate public interest or benefit that might be served by its disclosure. Thus, the Congress decided to make it clear that certain data used by the Revenue Service to establish its criteria for audit selection (including any such data that was being sought in any pending litigation) should be confidential if the Secretary determines that confidentiality is necessary to protect the integrity of the tax system.

Explanation of Provision

The Act provides that nothing in the tax law, or in any other Federal law, may be construed to require the disclosure either of standards used, or to be used, for the selection of returns for examination, or of data used, or to be used, for determining such standards, if the Secretary of the Treasury determines that such disclosure will seriously impair assessment, collection, or enforcement under the internal revenue laws.

The Congress intended that this provision is not to be construed to limit disclosure of statistical data or other information (other than of the type that could be used by the Revenue Service to determine standards for selecting returns for examination) to the extent permitted under prior law. Specifically, this provision is not intended to prohibit the release of TCMP data that was made available previously by the IRS on a general or routine basis to the general public. Thus, any information that previously was made available by the IRS generally should continue to be available to the extent permitted under prior law.[3]

Effective Date

The provision applies to disclosures after July 19, 1981.

Revenue Effect

The provision is estimated to have no effect on budget receipts.

[3] That is, it specifically is intended that persons to whom certain information was made available under secs. 6103 (returns and return information) or 6108 (statistical publications and studies) prior to the enactment of this provision should not have their access limited by this provision.

B. Changes in Interest Rate for Overpayments and Underpayments

(Sec. 711 of the Act and sec. 6621 of the Code)*

Prior Law

The interest rate applicable to tax underpayments and overpayments (the "tax interest rate") is prescribed by the Treasury Department pursuant to Code section 6621(a).

Prior law generally set the tax interest rate at 90 percent of the "average predominant prime rate quoted by commercial banks to large business, as determined by the Board of Governors of the Federal Reserve System." The statute required the Treasury to establish a new tax interest rate by October 15 of any applicable year if 90 percent of the average predominant prime rate for the preceding September was at least one full percentage point above or below the existing tax interest rate. A new tax interest rate was effective for the period beginning on February 1 of the year immediately succeeding that in which it was established, and ending with the earlier of the tax payment or the effective date of a new tax interest rate. Adjustments in the tax interest rate could not be made more frequently than every 23 months.

The tax interest rate at the time of enactment of the Act, for the period from February 1, 1980, was 12 percent.

Reasons for Change

The Congress believed that the interest rate applicable to tax refunds and deficiencies should coincide more closely with the actual cost of borrowing than it did under prior law.

In earlier years, the tax interest rate exceeded both the prime interest rate and the average interest rate on grade Aaa bonds, providing an incentive to the Treasury to credit or refund tax overpayments expeditiously. Also, taxpayers had been encouraged to compute their taxes accurately and to pay them promptly, and both taxpayers and the Government had an incentive to conclude controversies in a timely manner. In recent years, however, the tax interest rate has been significantly lower than the cost of commercial borrowing. For example, in calendar year 1980, the tax interest rate was 12 percent, while the average prime rate was 15.27 percent.

The Congress believed that the disparity between the tax interest rate and the actual cost of borrowing contributed to the increasing number and value of delinquent tax accounts. From 1978 to 1980, for example, the number of delinquent tax accounts increased from

*For legislative background of the provision, see H.R. 4242, as reported by the House Ways and Means Committee, sec. 711; H. Rep. No. 97-201 (July 24, 1981), pp. 240-241; H.R. 4242, as passed by the House (July 29, 1981), sec. 711; and H. Rep. No. 97-215 (August 1, 1981), p. 261 (Joint Explanatory Statement of the Committee of Conference).

886,000 to 1,204,000, and the value of delinquent accounts increased from $2,356 million to $3,631 million. A similar pattern was discernible from the cases filed in the U.S. Tax Court.

Thus, in order to encourage timely refunds and tax payments, and to make certain that "borrowing" through the non-payment of tax is no more attractive than other borrowing, the Congress decided to modify the rules for determining the tax interest rate.

Explanation of Provision

The Act requires that the tax interest rate be set at 100 percent, rather than 90 percent, of the average predominant prime rate, and that the tax interest rate is to be set annually. That is, the Secretary of the Treasury will establish a new tax interest rate by October 15 of any applicable year if 100 percent of the average predominant prime rate for the preceding September is at least one full percentage point above or below the existing tax interest rate. Accordingly, the first tax interest rate established pursuant to these new rules will become effective on February 1, 1982.

Beginning in 1983, any new interest rate will become effective on January 1, rather than on February 1, of the year immediately following that in which the rate is set.

Effective Date

The provision generally applies to interest rate adjustments made after the date of enactment of the Act (i.e., after August 13, 1981). The change in the effective date for adjusted interest rates applies to adjustments made for periods after 1982.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $100 million in 1982, by $100 million in 1984, and by $60 million in 1986. The provision is estimated to reduce budget receipts by less than $5 million in 1983 and by $100 million in fiscal year 1985.

C. Changes in Certain Penalties and in Requirements Relating to Returns

1. Changes in penalties for furnishing false information with respect to income tax withholding (sec. 721 of the Act and secs. 6682 and 7205 of the Code)*

Prior Law

Under prior law, individuals who claimed wage withholding allowances based on false information were subject to a civil penalty of $50 (sec. 6682).

The maximum criminal penalty for willfully failing to supply information, or for willfully supplying false or fraudulent information, in connection with wage withholding was a fine of $500 and one year imprisonment (sec. 7205).

Reasons for Change

The Congress believed that the penalties for filing false information in connection with wage withholding should be more significant than under prior law. In recent years, it appeared that some individuals did not consider the prior law monetary penalties to be a significant deterrent to supplying false wage withholding information. To attempt to correct this situation, the Congress decided to increase those penalties.

Explanation of Provision

The Act increases to $500 the civil penalty for filing false information with respect to wage withholding. This penalty applies if an individual makes a statement with respect to wage withholding (sec. 3402) which decreases from the proper amounts the amounts deducted and withheld, if there was no reasonable basis for the statement at the time it was made.

Because it applies generally to wage withholding, the penalty applies to statements which provide the basis for determining the amount to be withheld. Thus, for example, the penalty applies to statements relating to withholding exemptions (sec. 3402(f)), withholding allowances (sec. 3402(m)), and absence of tax liability (sec. 3402(n)).

Under the Act, the penalty may be waived by the Treasury Department if the individual's income taxes for the taxable year do not exceed the sum of the individual's estimated income tax payments and tax credits.

The Act also increases to $1,000 the maximum fine which may be imposed as a criminal penalty for willfully failing to supply infor-

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 721; H. Rep. No. 97-201 (July 24, 1981), p. 242; H.R. 4242, as passed by the House (July 29, 1981), sec. 721; and H. Rep. No. 97-215 (August 1, 1981), p. 261 (Joint Explanatory Statement of the Committee of Conference).

mation, or for willfully supplying falsified information, in connection with wage withholding.

Effective Date

The provision is effective for acts and failures to act after December 31, 1981.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million annually.

2. Penalty for valuation overstatements (sec. 722 of the Act and new sec. 6659 of the Code)*

Prior Law

Taxpayers who underpay tax are subject to an addition to tax, or penalty, if the underpayment is due to negligence or civil fraud (sec. 6653). If an underpayment is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), the penalty is five percent of the underpayment. The alternative civil fraud penalty is 50 percent of any underpayment. For purposes of these penalties, an underpayment generally is a deficiency (that is, the difference between the correct tax liability for the year and the tax shown on the taxpayer's return for the year, as decreased by rebates and increased by prior assessments or collections).

Prior law did not impose a penalty, or addition to tax, specifically applicable to underpayments of tax resulting from overstatements of the value of property.

Reasons for Change

The Congress believed that a specific penalty was needed to deal with various problems related to the valuation of property. This particular need is illustrated by the fact that there are about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance. These cases alone involve approximately $2.5 billion in tax attributable to the valuation issues.

The Congress recognizes that valuation issues frequently involve difficult questions of fact. Often, these issues seem to be resolved simply by "dividing the difference" in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, the Congress believes that taxpayers were encouraged to overvalue certain types of property and to delay the resolution of valuation issues. Since the tax interest rate under prior law had been below the prevailing cost of borrowing, this tendency probably was accentuated somewhat.

In recognition of the fact that valuation issues often are difficult, especially where unique property is concerned, the Congress decided to adopt a test for the application of a new penalty under which only significant overvaluations will be penalized. This approach to the problem, however, is not intended to condone minor overvaluations; rather, it is intended to remove questions involving small differences from the ambit of this new penalty.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 722(a); H. Rep. No. 97-201 (July 24, 1981), pp. 243-244; H.R. 4242, as passed by the House (July 29, 1981), sec. 722(a); and H. Rep. No. 97-215 (August 1, 1981), p. 262 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

Overview

The Act provides a new penalty in the form of a graduated addition to tax applicable to certain income tax "valuation overstatements." [1] As an addition to tax, this penalty will be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to the extent of any income tax underpayment which is attributable to such an overstatement, and only if the taxpayer is an individual, a closely held corporation, or a personal service corporation. For example, assume that an individual understates income tax liability for the taxable year by $5,000, and that of the $5,000 underpayment, $2,000 is attributable to overstating the value of property. In this case, only the portion of the tax underpayment that is attributable to overstating the value of the property (i.e., $2,000) is subject to the penalty.

The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.[2]

The application of the valuation overstatement penalty will not preclude the application of other penalties against a taxpayer. For example, in a proper situation, the valuation overstatement penalty, as well as the five-percent negligence penalty, or other penalty or penalties, might be assessed against the same taxpayer.[3]

Valuation overstatements

Under the Act, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the

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[1] The valuation overstatement penalty applies only with respect to valuation overstatements for purposes of the income tax. Thus, for example, the overvaluation of property for estate tax purposes on the return of an estate will not give rise to the penalty with respect to the estate. However, if property is overvalued for estate tax purposes, and such overvaluation subsequently results in an underpayment on an income tax return, the overvaluation penalty then could arise. This could occur, for example, if an individual who inherited property from a decedent sold such property and underreported the gain therefrom because the estate tax valuation of the property, which later was used to report gain by the individual on the sale of the property, was inflated substantially. In this case, the penalty would be applied against the heir.

[2] The determination of the portion of a tax underpayment that is attributable to a valuation overstatement may be illustrated by the following example. Assume that in 1982 an individual files a joint return showing taxable income of $40,000 and tax liability of $9,195. Assume, further, that a $30,000 deduction which was claimed by the taxpayer as the result of a valuation overstatement is adjusted down to $10,000, and that another deduction of $20,000 is disallowed totally for reasons apart from the valuation overstatement. These adjustments result in correct taxable income of $80,000 and correct tax liability of $27,505. Accordingly, the underpayment due to the valuation overstatement is the difference between the tax on $80,000 ($27,505) and the tax on $60,000 ($17,505) (i.e., actual tax liability reduced by taking into account the deductions disallowed because of the valuation overstatement), or $9,800.

[3] If both the valuation overstatement penalty and the five-percent negligence penalty apply, the valuation overstatement penalty will be applied against the portion of the tax underpayment due to the valuation overstatement and the negligence penalty will be applied separately against the entire amount of the underpayment. The amounts resulting from the separate application of these two penalties then would be added together to determine the total amount of penalites assessable against the taxpayer.

correct amount of the valuation, or adjusted basis. If there is a valuation overstatement, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	*The applicable percentage is—*
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The operation of the provision may be illustrated by the following example. Assume that a painting, which has been valued by a taxpayer (with a 50 percent marginal rate) at $500,000 for income tax purposes, is finally determined to have a value of $100,000. As a result of overstating the value of the painting, the taxpayer had claimed a $500,000 charitable contribution deduction for the year she donated it to a museum, thereby reducing her tax liability by $250,000. Had the taxpayer claimed only the charitable deduction to which she was entitled ($100,000), her tax liability would have been reduced by $50,000. Thus, due to the valuation overstatement, the taxpayer underpaid her income tax liability by $200,000. Accordingly, the addition to tax applicable to the valuation overstatement would be $60,000 (i.e., 30 percent of $200,000).

Exceptions and waiver provisions

There are two exceptions to the new penalty. First, the valuation overstatement penalty does not apply if the underpayment for a taxable year attributable to the valuation overstatement is less than $1,000. Second, the penalty is inapplicable to any property which, as of the close of a taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than five years.

In addition, the Act grants the Treasury Department discretionary authority to waive all or part of the penalty on a showing by a taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that the claim was made in good faith.

Definitions

For purposes of the penalty, the term "underpayment" has the same meaning as under the present law rules relating to negligence and civil fraud penalties (sec. 6653(c)(1)).[4]

The new addition to tax applies only to individuals, closely held corporations, and personal service corporations. A closely held corporation is defined as a corporation (described in sec. 465(a)(1)(C),

[4] That is, generally, the excess of the amount of tax that should have been paid over the amount shown on the return plus any amounts previously assessed or collected.

relating to at-risk rules) with respect to which more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (see sec. 542(a)(2)). A personal service corporation is a corporation which is a service organization (within the meaning of sec. 414(m)(3), relating to pension plans).

Effective Date

The provision applies to returns filed after December 31, 1981. Since the provision applies to returns filed after December 31, 1981, property that has been overvalued on a return filed prior to that date may give rise to the penalty on a return filed after December 31, 1981, if the original overvaluation produces a tax underpayment on the later filed return (and if the property has not been held for more than five years as of the close of the taxable year). Moreover, the provision could be applicable in situations where overvaluations in one year result in carryovers to future years which give rise to underpayments in those years. This will be the case in any situation in which an overvaluation of property in one year produces a tax benefit in that year which, in turn, has the result of producing a tax benefit in a future year (or future years).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

3. Increase in negligence penalty (sec. 722(b) of the Act and sec. 6653(a)(2) of the Code)*

Prior Law

A taxpayer who underpays taxes because of negligence or civil fraud is subject to certain penalties (sec. 6653). The penalty for negligence is five percent of any underpayment that is due, to any extent, to negligent or intentional disregard for rules and regulations but not with intent to defraud. The alternative civil fraud penalty is 50 percent of any underpayment. For purposes of these penalties, an underpayment generally is a deficiency (that is, the difference between the correct tax liability for the year and the tax shown on the taxpayer's return for the year, as decreased by rebates and increased by prior assessments or collections).

Under prior law, the interest imposed with respect to an underpayment of taxes was not increased if the underpayment resulted from negligence or civil fraud.

Reasons for Change

The Congress believed that the negligence penalty should be augmented to encourage accurate compliance with tax laws. After considering alternative ways of accomplishing this objective, the Congress decided that linking the penalty with the interest payable on tax underpayments will be an effective method of giving taxpayers an extra incentive to make sure that their actions or inactions are not negligent. In addition, by linking the new penalty to the interest payable on underpayments, the Congress believed that there will be less incentive to delay unduly the settlement of outstanding tax disputes.

Explanation of Provision

The Act imposes an addition to tax equal to 50 percent of the interest (determined under sec. 6601) payable with respect to that portion of an underpayment which is attributable to negligent or intentional disregard for rules or regulations. The addition to tax is 50 percent of the interest for the period beginning on the last day for payment of the underpayment (i.e., the due date of the return without regard to any extension of time for payment) and ending on the date of the assessment.[1]

This new penalty is in addition to the five-percent negligence penalty already in effect. However, unlike that penalty which is applied against the entire underpayment, this penalty applies only

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 722(b); H. Rep. No. 97-201 (July 24, 1981), p. 245; H.R. 4242, as passed by the House (July 29, 1981), sec. 722(b); and H. Rep. No. 97-215 (August 1, 1981), p. 263 (Joint Explanatory Statement of the Committee of Conference).

[1] This is the same rule that applies in the case of interest on underpayments of tax under sec. 6601.

against the portion of the underpayment that results from negligence or intentional disregard for rules or regulations.

For example, if a taxpayer owed a total of $2,000 of interest with respect to a tax underpayment, and $1,000 of that interest was attributable to the portion of the tax underpayment which was due to negligence, then in addition to interest and the five-percent negligence penalty, the taxpayer would owe $500 (i.e. 50 percent of $1,000).

If there has been an underpayment of tax that is attributable, in part, to negligence and, in part, to other items, then the portion of the underpayment that is due to negligence will be determined after taking into account any other proper adjustments to tax liability. Thus, the determination of the portion of the underpayment attributable to negligence will be accomplished in the same manner as the determination of the portion of an underpayment that is due to a valuation overstatement.

As an addition to tax, rather than additional interest, amounts imposed under this new penalty are not deductible.

Effective Date

The provision applies to taxes the last date for payment of which is after December 31, 1981

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

4. Increases in penalties for failure to file certain information returns (sec. 723 of the Act and secs. 6041, 6652, and 6678 of the Code)*

Prior Law

The Code requires taxpayers to file a variety of information returns with the Internal Revenue Service. Generally, these returns relate to payments to, and transactions with, other persons.

Under prior law, the penalty for failure to file most information returns was $1 per return, subject to a maximum of $1,000 for any calendar year (sec. 6652(b)). Also, under prior law, a taxpayer who was required to file an information return generally did not have to furnish a copy of the return to the person to whom the payment shown on the return related. However, such a requirement was imposed with respect to some information returns (sec. 6678), such as information returns relating to the payment of certain dividends or interest.

Reasons for Change

The Congress believed that persons to whom payments shown on information returns relate are entitled to receive a copy of the return, especially since the payment shown on the return could affect their tax liability. In addition, the Congress believed that the penalties for failure to comply with obligations relating to information returns should be increased to encourage payors to comply with those obligations.

Explanation of Provision

Requirement to furnish return

The Act generally requires that information returns be furnished (under Code sec. 6678) to the persons to whom the payments on the returns relate. The returns which must be furnished to such persons are those required by section 6041(a), relating to certain payments of $600 or more; section 6050A(b), relating to certain fishing boat operators; section 6050C, relating to the windfall profit tax; section 6051, relating to income tax withheld; and section 6053(b) relating to tips.[1]

Failure to furnish copies of returns to payees as required subjects the taxpayer to a penalty of $10 for each failure, up to a maximum

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 723; H. Rep. No. 97-201 (July 24, 1981), pp. 246-247; H.R. 4242, as passed by the House (July 29, 1981), sec. 723; and H. Rep. No. 97-215 (August 1, 1981), p. 261 (Joint Explanatory Statement of the Committee of Conference).

[1] Information returns continue to be required to be furnished to the persons to whom they relate in the case of returns required by section 6042(a)(1), relating to payments of dividends aggregating $10 or more; section 6044(a)(1), relating to payments of patronage dividends aggregating $10 or more; section 6049(a)(1), relating to payments of interest aggregating $10 or more; section 6052(a), relating to payments of wages in the form of group-term life insurance; and section 6039(a), relating to information required in connection with certain options.

penalty of $25,000 for any calendar year. The penalty is not applicable, however, if the taxpayer's failure is due to reasonable cause and not to willful neglect. (An example of reasonable cause might be the unavailability of a current address for the payment's recipient.) These generally are the same rules and penalty that applied under prior law in those situations in which such a statement was required to be furnished (e.g., statements with respect to payments of dividends and interest aggregating $10 or more).

The statement required for payments of $600 or more must be furnished on or before January 31 of the year following the calendar year to which the return relates.

Increased penalties

The provision also increases the penalty for failure to file certain information returns with the Revenue Service. The returns with respect to which the increased penalty applies are those required by section 6041 (a) or (b), relating to certain information at the source; section 6050A(a), relating to fishing boat operators; and section 6051(d), relating to information returns with respect to withheld income taxes.[2]

The increased penalty is $10 for each return, subject to a maximum penalty of $25,000 for any calendar year. As under prior law, the penalty does not apply if the failure is due to reasonable cause and not to willful neglect.

Because the obligation to furnish a statement and the requirement to file an information return are different obligations, a taxpayer may be subject to both the information and statement penalties.

The Act retains the $1 penalty for failure to file information returns with respect to certain payments aggregating less than $10.[3]

Effective Date

The provision applies to returns and statements required to be furnished after December 31, 1981.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

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[2] The $10 per return penalty continues to apply to returns required by section 6042(a)(1), relating to dividend payments aggregating $10 or more; section 6044(a)(1), relating to patronage dividends aggregating $10 or more; section 6049(a)(1), relating to interest payments of $10 or more; and section 6052(a), relating to payments of wages in the form of group-term life insurance.

[3] These are the returns specified in secs. 6042(a)(2) (payments of dividends aggregating less than $10), 6044(a)(2) (payments of patronage dividends aggregating less than $10), 6049(a)(2) (payments of interest aggregating less than $10), and 6049(a)(3) (other payments of interest by corporations). These returns need be filed only if required by Treasury regulations.

5. Penalty for overstated tax deposit claims (sec. 724 of the Act and new sec. 6656(b) of the Code)*

Prior Law

Certain taxpayers are required to make periodic deposits of various taxes prior to the close of the taxable year (see, for example, sec. 6302, relating to tax deposits). A taxpayer who fails to comply with tax deposit requirements is subject to a penalty equal to five percent of any underpayment [1] (sec. 6656(a)). This penalty is excused if the failure is due to reasonable cause and not to willful neglect. In addition, criminal penalties apply to a taxpayer who makes a false return claiming to have made tax deposits (sec. 7206), or who fails to collect, account for, or pay over collected taxes (sec. 7215).[2]

Although there was a penalty for failure to make tax deposits, prior law did not impose a specific civil penalty on taxpayers who falsely claimed to have made tax deposits.

Reasons for Change

The Congress was concerned that the failure to deposit taxes had become a serious delinquency problem. In particular, the Congress was troubled by the fact that employers who claimed fictitious deposits of taxes could significantly delay Internal Revenue Service collection efforts but were penalized no more than employers who admitted underpayments on their tax returns.

Accordingly, the Congress decided that a specific civil penalty should apply to persons who claim falsely to have made deposits of taxes which, in fact, were not deposited as required, and to persons who falsely overstate the amounts of deposits.

Explanation of Provision

The Act provides a specific civil penalty applicable to persons who make overstated deposit claims. This penalty is an amount equal to 25 percent of the overstated deposit claim. The penalty will apply in addition to any other applicable penalties. However, it will not apply if an overstated deposit claim is due to reasonable cause and not due to willful neglect.

An overstated deposit claim, for purposes of this provision, is the excess of (1) the tax claimed, in a return filed with the Treasury (Internal Revenue Service), to have been deposited in a government depository for any period over (2) the aggregate amount deposited

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 724; H. Rep. No. 97-201 (July 24, 1981), p. 248; H.R. 4242, as passed by the House (July 29, 1981), sec. 724; and H. Rep. No. 97-215 (August 1, 1981), p. 262 (Joint Explanatory Statement of the Committee of Conference).

[1] An underpayment, for this purpose, is the excess of the amount of tax required to be deposited over the amount of tax, if any, that is deposited on or before the prescribed date.

[2] The maximum penalty under sec. 7206 is a $5,000 fine and three years' imprisonment. The maximum penalty under sec. 7215 is a $5,000 fine and one year's imprisonment.

in a government depository, for that period, on or before the date that the return is filed. Thus, overstated deposit claims include failures to deposit, claims of deposits in excess of the amount actually deposited in a government depository, and claims of deposits which are not deposited in such a depository. However, overstated deposit claims do not include accurate and timely deposits of taxes required to be deposited which are deposited in a government depository other than the one indicated on the return filed.

The Act also provides for the assessment, collection, and payment of the penalty in the same manner as is applicable to the assessment, collection, and payment of taxes.

Effective Date

The provision applies to returns filed after the date of enactment of the Act (August 13, 1981).

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

6. Declaration and payment of estimated taxes by individuals (sec. 725 of the Act and secs. 6015 and 6654 of the Code)*

Prior Law

Declaration requirements

Except as otherwise provided, declaration and payment of estimated tax must be made by a single person, or a married couple with one earner entitled to file a joint return, whose gross income is expected to exceed $20,000 for the taxable year; by a married individual entitled to file a joint return, whose gross income is expected to exceed $10,000 for the taxable year, if both spouses receive wages; and by a married individual, not entitled to file a joint return, whose gross income is expected to exceed $5,000 (sec. 6015). In addition, an individual taxpayer who expects to receive more than $500 from sources other than wages during the year is required to file a declaration of estimated tax. Thus, for example, an individual who expects to receive more than $500 during the taxable year in the form of dividends and interest payments generally is required to pay estimated taxes on those amounts.

However, under prior law, no declaration was required if an individual's tax liability for the year, including self-employment tax liability, reasonably could be expected to be less than $100 over the amounts withheld during the year.

Penalties

An individual who fails to pay in full an installment of estimated tax on or before the due date may be subject to a penalty (at the rate established under sec. 6621) which may not be waived for reasonable cause (sec. 6654). This penalty, which is applied to the period of underpayment of any installment, applies to the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made.

In addition, there are four exceptions to the general underpayment penalty. No penalty is imposed upon a taxpayer if: (1) total tax payments (withholding plus estimated tax payments) exceed the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) total tax payments exceed the tax based on the facts shown on the prior year's return under the current year's tax rates and exemptions; (3) total tax payments exceed 80 percent of the taxes which would be due if the income already received during the current year were placed on an annual basis; or (4) total tax payments exceed 90 percent of the tax which

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 725; H. Rep. No. 97-201 (July 24, 1981), pp. 249-250; H.R. 4242, as passed by the House (July 29, 1981), sec. 725; and H. Rep. No. 97-215 (August 1, 1981), p. 265 (Joint Explanatory Statement of the Committee of Conference).

would be due on the income actually received from the beginning of the year to the computation date.

Reasons for Change

The Congress was concerned that the $100 tax liability threshold for filing estimated taxes was too low. Often, individuals with modest amounts of income not subject to withholding discover that they either must declare and pay estimated taxes or subject themselves to penalties for failure to do so. Accordingly, the Congress decided to raise the tax liability threshold for individual estimated tax payments to $500. At the same time, in order to minimize the immediate potential revenue loss of this change, the Congress decided to phase in the increase over a four-year period.

Explanation of Provision

Under the Act, the tax liability threshold for the payment of estimated taxes by individuals will be increased to $500 by 1985. Thus, in 1985 and subsequent years, no declaration of estimated tax will be required if an individual's tax liability for the year, including self-employment tax liability, reasonably can be expected to be less than $500 over amounts withheld during the year. The increase in the tax liability threshold is phased in over a four-year period beginning in 1982. For 1982, the tax liability threshold will be $200; for 1983, $300; for 1984, $400; and for 1985 and subsequent years, $500.

The Act also provides that, in 1985 and subsequent years, no penalty will be imposed upon an individual for failure to pay estimated tax if the tax shown on the individual's return (or, if no return is filed, the tax) is less than $500.[1] This exception to the penalty for failure to pay estimated taxes is phased in in the same manner as the increase in the tax liability threshold.

Effective Date

The provision applies to estimated tax for taxable years beginning after December 31, 1980.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $44 million in 1982, $29 million in 1983, $38 million in 1984, $40 million in 1985, and $38 million in 1986.

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[1] The Congress intended that no penalty should be imposed for failure to pay estimated taxes in any situation in which an individual is not required to make a declaration of estimated taxes because the taxes estimated by the individual do not exceed the tax liability threshold. For example, it was intended that if, in 1985 and subsequent years, an individual is not required to make a declaration of estimated taxes because that individual's tax liability, including self-employment tax liability, reasonably can be expected to be less than $500 over amounts withheld during the year then such individual should not be penalized for failure to file a declaration.

D. Cash Management

Corporate estimated tax payments (sec. 731 of the Act and sec. 6655 of the Code)*

Prior Law

Payment requirements

A corporation must make estimated tax payments if the estimated tax for the taxable year can reasonably be expected to be $40 or more (sec. 6154). In general, a corporation's estimated tax is the estimated income tax (other than the minimum tax) less any estimated credits against the tax.

Any corporation required to make estimated tax payments must make such payments in installments, as shown by the following table:

If the $40 threshold is first met—	*The following percentages of the estimated tax shall be paid on the 15th day of the—*			
	4th mo.	*6th mo.*	*9th mo.*	*12th mo.*
Before the 1st day of the 4th month of the taxable year	25	25	25	25
After the last day of the 3d month and before the 1st day of the 6th month of the taxable year		33⅓	33⅓	33⅓
After the last day of the 5th month and before the 1st day of the 9th month of the taxable year			50	50
After the last day of the 8th month and before the 1st day of the 12th month of the taxable year				100

Penalty provisions

A corporation that fails to pay the required estimated tax when due is subject to an underpayment penalty (sec. 6655). The penalty is computed for the period of underpayment, determined under section 6655, at a rate determined under section 6621. For purposes of the penalty, the amount of underpayment is the excess of (1) the amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent of the tax shown on the

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8712-S8713 (daily ed. July 29, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 731; H. Rep. No. 97-201 (July 24, 1981), pp. 251-253; H.R. 4242, as passed by the House (July 29, 1981), sec. 731; and H. Rep. No. 97-215 (August 1, 1981), p. 265 (Joint Explanatory Statement of the Committee of Conference).

return for the taxable year (or if no return was filed, 80 percent of the tax for such year) over (2) the amount, if any, of the installment paid on or before the last date prescribed for payment.

In general, no penalty is charged with respect to the underpayment of a corporation's estimated tax liability if the corporation made payments on or before the due date of the installment and the total payments up to the particular due date in question equal or exceed the amount which would have been due had the estimated tax been based on any of the following amounts: (1) the preceding year's liabilities, if a return showing a tax liability was filed by the corporation for the preceding taxable year and such preceding year was a taxable year of 12 months; (2) tax liabilities computed by using the current year's tax rates for the prior year's return and the law that applies to the prior year; or (3) 80 percent of the taxes which would have been due if the income which the corporation had already received during the current year had been placed on an annualized basis.

However, in the case of the two exceptions based upon prior year's tax liability (items (1) and (2) above), a special rule applies to large corporations. Under prior law, this special rule provided that the estimated tax payments of a large corporation generally must equal at least 60 percent of the tax shown on its income tax return for the taxable year (or the actual tax if no return is filed). A large corporation, for purposes of this requirement, is a corporation (including any predecessor corporation) that had taxable income of $1 million or more in any of the three taxable years immediately preceding the taxable year involved.

In the case of component members of a controlled group of corporations (within the meaning of sec. 1563), the $1 million amount for any taxable year in the three-year base period is divided among the members of the group in the same manner in which the benefits of the graduated tax rates are allocated for that year.

Reasons for Change

The Congress believed there is no reason to permit large corporations to be only 60 percent current in tax payments because they had little or no tax liability in their prior year. Allowing these corporations to pay less than the generally required 80 percent of current year tax liability amounted, in effect, to a substantial interest-free loan from the Federal Government. Thus, the Congress decided to eliminate, over a three-year period, the prior year exceptions to the general estimated tax penalty rules in the case of large corporations.

Explanation of Provision

The Act eliminates, for taxable years beginning in 1984, the "prior year" exceptions to the general estimated tax penalty rules in the case of large corporations. In 1982, large corporations which meet one of the prior year exceptions must be at least 65 percent current with estimated tax payments. This amount will increase to 75 percent in 1983, and to 80 percent in 1984 and subsequent years.

The Act retains the prior law definition of a large corporation and retains the same allocation rules for component members of a controlled group of corporations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $614 million in 1982, $1,522 million in 1983, $1,190 million in 1984, and $201 million in 1985. The provision is estimated to reduce budget receipts by $142 million in fiscal year 1986.

E. Financing of Railroad Retirement System

1. Increases in employer and employee taxes (sec. 741 of the Act and secs. 3201, 3211, 3221, and 3231 of the Code)*

Prior Law

Prior law imposed a tax on railroad employers of 9.5 percent of compensation paid to railroad employees in a calendar month, subject to a maximum limitation (Code sec. 3221(a)). For 1981, the annual taxable compensation base is $22,200; however, in no case does the tax apply to any amount paid in a month in excess of one-twelfth of the annual limitation. The annual (and monthly) limitation on taxable compensation for the purposes of section 3221(a) is indexed pursuant to sections 230 (c) and (d) of the Social Security Act.

Further, under prior law (sec. 3231(e)(1)(iii)), payments made by railroad employers of railroad employee taxes under section 3201 without deduction from the remuneration of the employee were excluded from the definition of compensation for the purposes of the Railroad Retirement Tax Act ("RRTA").

Reasons for Change

In 1974, the Congress reorganized the Railroad Retirement System into three main benefit components. The first two major components, known as "tiers", roughly approximated social security (tier I) and an industry staff retirement benefit (tier II). Tier II was designed to approximate the structure of a private industry pension plan, with benefits related to service in the railroad industry and financed by taxes on industry employers.

For the last ten years, the revenues raised from railroad retirement tax have been inadequate to finance existing benefit levels. The anticipated yearly deficit for fiscal year 1981 was nearly $835 million, and there was no expectation under prior law tax and benefit provisions that the deficit would narrow.

The urgency of Congressional action to restore the system to financial soundness was underscored by Administration and Congressional Budget Office projections that, under prior law, insufficient balances for the purpose of making full benefit disbursement would probably occur in the Railroad Retirement Account as early as the spring of 1982. The shortfall would have been temporarily alleviated by that year's financial interchange with the social security system, but would recur in the spring of 1983, with complete insolvency predicted within two years after that. Since the Rail-

*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 741; H. Rep. No. 97-201 (July 24, 1981), pp. 254-255; H.R. 4242, as passed by the House (July 29, 1981), sec. 741; and H. Rep. No. 97-215 (August 1, 1981), pp. 265-267 (Joint Explanatory Statement of the Committee of Conference).

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road Unemployment Insurance Account is authorized to borrow needed funds from the Railroad Retirement Account, the potential insolvency of the Railroad Retirement Account could also result in an inability to make timely unemployment-sickness benefit payments.

The Congress undertook to develop a Federally administered retirement program for railroad employees in the early 1930's in response to a growing need for placing the variety of pension plans within the railroad industry on a reasonably sound financial basis. Since establishment of the Railroad Retirement system in 1937, the Congress has traditionally given the leading role in developing solutions to problems within that system to railroad management and labor in recognition of the trustee-like role performed by the Federal Government in administration of the tier II portion of the program. Over the last three years, representatives of management and labor have sought agreement for placing the system on a sound financial basis. The provisions adopted by the Congress in the Act reflect the agreement negotiated by representatives of railway management and labor, in addition to benefit restructuring included in the Omnibus Reconciliation Act of 1981 (P.L. 97-35).

The Congress, in its review of Railroad Retirement system financing and the provisions of the RRTA, also decided to conform provisions of that Act to corresponding tax provisions of the Federal Insurance Contributions Act ("FICA"). Generally, until 1981, payments by an employer of an employee's FICA tax liability were excluded from the definition of taxable wages for tax and benefit computation purposes (Code sec. 3121(a)(6) and sec. 209(f) of the Social Security Act). The exclusion of such payments from the definition of wages for FICA tax and social security benefit computation purposes was eliminated by section 1141(a)(1) of the Omnibus Reconciliation Act of 1980 (P.L. 96-499).

In amending the provisions of the Federal Insurance Contributions Act that had excluded employer-paid employee FICA taxes from the definition of taxable wages, the Congress responded to concerns about the effect certain payroll practices utilizing the exclusion were having on the reported earnings of workers for benefit computation purposes and the potential such practices had for eroding the social security tax base. While such payments previously had been excluded from taxable compensation for employment tax purposes, they have always been considered gross income to employees for Federal income tax purposes.

Explanation of Provision

The Act increases the rate of tax on railroad employers under section 3221(a) and imposes a new tax on railroad employees under section 3201. The rate of tax on railroad employers is increased from 9.5 to 11.75 percent of taxable compensation (subject to the annual and monthly limitations). In addition, there is imposed a tax, in addition to other taxes under the RRTA, of 2.0 percent on taxable compensation (within the same limitations as apply to employers) of railroad employees. For the purposes of both the employer and employee railroad taxes, taxable compensation is that amount of compensation determined in accordance with the provisions of sections 230(c) and 230(d) of the Social Security Act.

The new 2.0 percent tax on employees will be collected by the employer by deducting the amount of the tax from the compensation of the employee as and when paid, pursuant to the provisions of Code section 3202(a).

Also, the Act provides that payments by a railroad employer of employee railroad taxes under section 3201 without deduction from the remuneration of the employee, which had been excluded from the definition of compensation for the purposes of the RRTA, are included in taxable compensation for RRTA purposes.

Effective Date

The provision applies to compensation paid for services rendered after September 30, 1981.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $512 million in 1982, $555 million in 1983, $604 million in 1984, $657 million in 1985, and $712 million in fiscal year 1986.

2. Advance transfers to the railroad retirement account (sec. 742 of the Act and sec. 15 of the Railroad Retirement Act of 1974)*

Prior Law

Since 1946, the Railroad Retirement System and the social security programs have been coordinated. At present, the two systems are coordinated through a complex financial interchange, linking benefits and taxes under the three social security programs (Old Age, Disability, and Medicare) with the tier-I railroad benefit component. Generally, the purpose of the financial interchange, created by legislation in 1951, is to place the social security trust funds in the same position as if railroad employment had been covered under social security since its inception.

Generally, under the interchange, for a given fiscal year there is computed the amount of social security taxes that would have been collected if railroad employment had been covered directly by social security. This amount is netted against the amount of benefits social security would have paid to railroad beneficiaries based on railroad and nonrailroad earnings during that period. If social security benefits that would have been paid exceed social security taxes that would have been due, the excess, plus an allowance for interest and administrative expenses, is transferred from the Social Security Trust Funds to the Railroad Retirement Account. That transfer is currently estimated to be approximately $1.6 billion for fiscal year 1981. The determination of the amount to be transferred through the financial interchange for a given fiscal year is made in June of the year following the close of the preceding fiscal year.

There was no authority in prior law that would enable the Railroad Retirement Account to receive transfers of any other funds from the general fund of the Treasury. Revenues to the System were limited to automatically appropriated receipts from railroad retirement taxes, a Federal Government contribution for certain "windfall benefits", and interest earned on invested reserves.

Reasons for Change

Interest for the period of the delay on the financial interchange transaction is paid by the Social Security Trust Funds, so that the long-term financial condition of the Railroad Retirement System is not significantly affected. Nonetheless, the Congress is concerned that the amounts due under the interchange are paid only once per year and then on a delayed basis which can, under some circumstances, contribute to serious short-term cash flow problems.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 742; H. Rep. No. 97-201 (July 24, 1981), pp. 256-257; H.R. 4242, as passed by the House (July 29, 1981), sec. 742; and H. Rep. No. 97-215 (August 1, 1981), pp. 265-267 (Joint Explanatory Statement of the Committee of Conference).

Increases in railroad retirement taxes on railroad employers and their employees will partially alleviate the short-term cash flow problems of the System. These additional revenues are complemented by various benefit reductions enacted as part of the Omnibus Reconciliation Act of 1981 (P.L. 97-35). Nevertheless, despite these revenue increases and benefit reductions, the financing of the system for a good part of this decade, while on an annual basis adequate to meet benefit obligations, commences at relatively low reserve levels; also, there remains the potential cash-flow crisis each spring because of the uneven flow of funds into the account.

Although a more current interchange with the social security Trust Funds could mitigate the fluctuation in the Railroad Retirement Account reserve levels, the one-time acceleration this would require would present a substantial drain on the social security system at a time when it too is operating on very low reserve levels. Accordingly, the Congress concluded that access to the delayed assets of the Account can be provided without imperiling the Social Security Trust Funds through a limited general fund borrowing authority.

Explanation of Provision

In order to make available to the Railroad Retirement Account funds from the forthcoming financial interchange in the event of inadequate reserves in months prior to the transfer, the Act establishes limited authority in the Railroad Retirement Board to request from the Secretary of the Treasury and receive from the general fund such amounts as the board and the trustees of the social security system may find necessary to maintain a balance in the Account sufficient to pay annuity amounts payable during the following month.

The total amount of monies outstanding in the Account from the general fund at any time during any fiscal year may not exceed the total amount of monies the Board and the trustees of the social security system estimate would be transferred under the financial interchange for such fiscal year. The rate of interest paid on amounts outstanding for any month equals the average investment yield for the most recent auction of Treasury bills with maturities of 52 weeks.

Effective Date

The provision applies as of August 13, 1981.

Revenue Effect

The provision is estimated to have no effect on unified budget receipts or outlays, although it might result in intrabudgetary transfers in some circumstances.

3. Clarification of the definition of compensation under the Railroad Retirement Tax Act (sec. 743 of the Act and sec. 3231 of the Code)*

Prior Law

The interpretation of prior law provisions concerning the timing of taxation of railroad compensation (Code sec. 3231) had remained unsettled for a number of years. In 1975, the Internal Revenue Service ruled (Rev. Rul. 75-266, 1975-2 C.B. 408) that for railroad retirement tax purposes, compensation was taxable on an as-earned basis. This ruling was inconsistent with established practices of many railroads. The railroads took the position that the statute required computation of the tax on an as-paid basis, pursuant to their interpretation of the 1946 amendments (P.L. 79-572, 60 Stat. 722).

These differing interpretations led to enactment of legislation in 1975. An amendment to H.R. 9091 was added in the Senate deleting the first sentence of Code section 3231(e)(2), which provided that a payment made to an individual through the employer's payroll was presumed, in the absence of evidence to the contrary, to be compensation for services rendered in the period with respect to which the payment is made (P.L. 94-93, 90 Stat. 466). The regulations promulgated under the deleted language, which had provided the underpinning for Rev. Rul. 75-266, had provided that compensation was earned when an employee rendered services for which the employee was paid, or for which there was an obligation to pay, regardless of the time at which payment was made. The amendment in P.L. 94-93 striking the first sentence of section 3231(e)(2) was made effective for taxable years ending on or after the date of enactment of that statute, and for taxable years ending before the date of enactment of that statute as to which the period of assessment and collection of tax or the filing of a claim for credit or refund had not expired.

Reasons for Change

The Congress enacted the 1975 legislation in response to a revenue ruling which was viewed as imposing serious administrative burdens on railroad employers and as establishing a taxing basis that might have been inconsistent with the "as-paid" method which employers used to report retroactive wage payments and which the Railroad Retirement Board used to credit such wages to employee accounts for benefit computation purposes.

Recently, it came to the attention of the Congress that an unintended possible result of the 1975 legislation may have been to introduce a new inconsistency in the law with respect to certain

*For legislative background of the provision, see: H.R. 4242, as passed by the House (July 29, 1981), sec. 743; and H. Rep. No. 97-215 (August 1, 1981), pp. 265-267 (Joint Explanatory Statement of the Committee of Conference).

wage payment practices of some railroad employers. It was understood that at least one railroad (and possibly others) had filed claims for refunds of already paid railroad employment taxes based on their interpretations of the law.

It appears to be a practice among certain railroads that if the normal wage payment date falls on a Saturday, Sunday, or holiday, wages will be paid on either the preceding or subsequent business day. This may cause wages to be paid in a month that is either prior to or subsequent to the month in which the wages normally would be paid. For example, if wages are paid ordinarily twice monthly, there may be three wage payments in one month and only one wage payment in another month. Comparable problems could arise if other payroll systems, such as one incorporating biweekly payments, are employed.

This possible bunching of income in certain months may significantly reduce employer and employee railroad retirement tax liability due to the fact that railroad retirement taxes are imposed only on monthly compensation not exceeding one-twelfth of the current social security tax wage base. The Congress believed that the bunching of income in certain months, solely as a result of particular payroll practices, should not affect the railroad employment tax liability of the employer based on that compensation, and that the presumption should be that such payments are considered compensation in the period with respect to which the payment is made.

Explanation of Provision

The Act amends section 3231(e)(2) by adding a new sentence at the beginning of that provision. The additional language is identical to the language stricken by section 205 of P.L. 94-93 in 1975.

The amendment provides that a payment (such as lump-sum retroactive wage payments and crew consists payments) made by an employer to an individual through the employer's payroll shall be presumed, in the absence of evidence to the contrary, to be compensation for service rendered by such individual as an employee of the employer in the period with respect to which the payment is made. Further, the Act provides that if compensation paid in one calendar month would have been payable in a prior or subsequent month but for the fact that the prescribed date of payment would fall on a Saturday, Sunday, or legal holiday, such compensation shall be deemed to have been paid in such prior or subsequent month.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

The Congress intended that no inference is to be drawn, for purposes of any administrative or judicial proceedings, from the amendments in the Act for taxable years beginning after 1981 as to Congressional intent with respect to prior legislation concerning the definition of compensation.

Revenue Effect

The provision is estimated to result in a negligible revenue loss.

F. Filing Fees

Fee for filing Tax Court petitions (sec. 751 of the Act and sec. 7451 of the Code)*

Prior Law

Under prior law, the U.S. Tax Court was authorized to impose a fee of up to $10 for the filing of any petition.

Reasons for Change

The Congress was concerned with substantial increases in the number of cases filed in the Tax Court. The Congress also was aware that the filing fee in U.S. District Courts is $60. Therefore, in order to conform the Tax Court filing fee with that of the U.S. District Courts and to attempt to reduce the number of nonmeritorious cases filed in the Tax Court, the Congress decided that the Tax Court filing fee should be raised from $10 to $60.

Explanation of Provision

The Act authorizes the Tax Court to impose a fee of up to $60 for the filing of any petition.

Effective Date

The provision applies to Tax Court petitions filed after December 31, 1981.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7928-29 (daily ed. July 18, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 264 (Joint Explanatory Statement of the Committee of Conference).

TITLE VIII.—MISCELLANEOUS PROVISIONS

A. Extensions

1. Extension of moratorium on issuance of fringe benefit regulations (sec. 801 of the Act and sec. 61 of the Code)*

Prior Law

Background

The Internal Revenue Code defines gross income as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that income includes compensation for services paid other than in money (Reg. § 1.61-2(a)(1)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[1]

In actual practice, however, the "economic benefit" test has not been rigidly followed in all situations. Thus, where compensation is paid in some form other than cash, issues as to taxability have been resolved by statutory provisions, regulations, and administrative rulings and practices which take account of several different factors.

Some "fringe benefits," such as the providing of health insurance by an employer for its employees, are expressly excluded from gross income by particular provisions of the Code; other benefits are excluded by legislation outside the Code. In addition, some exclusions have been based on judicial authority or on administrative practice. For example, some economic or financial benefits furnished as compensation have been treated as excluded from income on the basis of *de minimis* principles; that is, accounting for some benefits of small value may be viewed as unreasonably burdensome or administratively impractical. Other items have been treated as excluded in light of a combination of valuation difficulties and widely held perceptions that the particular items should not be taxed as income.

Proposed regulations

In 1975, the Treasury Department issued a discussion draft of proposed regulations [2] which contained a number of rules for determining whether various fringe benefits constitute taxable compen-

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8225-26 (daily ed. July 23, 1981); H.R. 4242, as reported by the House Ways and Means Committee, sec. 805; H. Rep. No. 97-201 (July 24, 1981), pp. 282-283; H.R. 4242, as passed by the House (July 29, 1981), sec. 805; and H. Rep. No. 97-215 (August 1, 1981), p. 268 (Joint Explanatory Statement of the Committee of Conference).

[1] *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945).

[2] 40 Fed. Reg. 4118 (Sept. 5, 1975).

sation. Under the principles proposed in the discussion draft, some employee fringe benefits which, as a matter of prior administrative practices, generally had not been considered to be taxable compensation would have been treated as subject to tax. Other benefits which might be viewed as taxable compensation would not have been taxed under proposed rules in the discussion draft.

The discussion draft was withdrawn by the Treasury Department on December 28, 1976.[3] Thus, the question of whether, and what, employee fringe benefits result in taxable income generally continues to depend on the facts and circumstances in each individual case.

Legislative moratorium

Public Law 95-427, enacted in 1978, prohibited the Treasury Department from issuing prior to 1980 final regulations, under Code section 61, relating to the income tax treatment of fringe benefits. That statute further provided that no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to 1980.

Public Law 96-167, enacted in 1979, extended the moratorium through May 31, 1981. That statute prohibited the Treasury Department from issuing prior to June 1, 1981 final regulations, under Code section 61, relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to June 1, 1981.

Reasons for Change

Although in recent years "fringe benefits" have accounted for an increasing percentage of employee compensation, few comprehensive or generally applicable income tax rules for the treatment of such economic or financial benefits have been developed. As a result, there has been an inevitable lack of uniformity of treatment of taxpayers who receive different types of benefits even though the benefits may have approximately the same economic value.

The determination of the appropriate income tax treatment of various benefits provided to employees has consequences aside from the issue of whether a benefit constitutes taxable compensation. Although there are differences between includible "compensation" for income tax purposes and "wages" for payroll tax purposes, the terms are used interchangeably. Thus, employers may be presented with the question of whether employment taxes should be withheld from employee wages on account of non-cash benefits provided to employees. In addition, both taxpayers and the Internal Revenue Service must face difficult problems of valuing benefits provided in kind.

While the Congress recognized that the Revenue Service constantly is reviewing the treatment of fringe benefits in accordance with its obligations to enforce the tax laws, the Congress also recognized that it is primarily the responsibility of the Congress to legislate tax policy. The Congress believed that a proper review of these issues requires an additional period of time.

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[3] 41 Fed. Reg. 5634 (Dec. 28, 1976).

Explanation of Provision

The Act extends the moratorium on issuance of fringe benefit regulations through December 31, 1983.

Under the Act, the Treasury Department (Internal Revenue Service) is prohibited from issuing prior to January 1, 1984 final regulations, under Code section 61, relating to the income tax treatment of fringe benefits.

In addition, no regulations relating to the treatment of fringe benefits under section 61 are to be proposed which would be effective prior to January 1, 1984.

Although the provision of the Act relates only to the issuance of regulations, it is the intent of the Congress that the Treasury Department (Internal Revenue Service) will not in any significant way alter, or deviate from, the historical treatment of traditional fringe benefits through the issuance of revenue rulings or revenue procedures, etc. The Act does not prevent the Treasury or Revenue Service from continuing to study the question of the appropriate tax treatment of fringe benefits.

Effective Date

The provision is effective on enactment of the Act (August 13, 1981).

Revenue Effect

The provision continues prior administrative practice and thus is estimated to have no effect on budget receipts.

2. Prepaid legal services (sec. 802 of the Act and sec. 120 of the Code)*

Prior Law

Employer contributions to, and benefits provided under, a qualified group legal services plan are excluded from an employee's income. Also, a trust forming a part of a qualified group legal services plan is generally exempt from Federal income tax.

Under prior law, the income exclusion would have expired with the employee's last taxable year ending before January 1, 1982, and the tax exemption would have expired with the last taxable year ending before January 1, 1982.

Reasons for Change

The Congress concluded that the income exclusion and tax exemption for qualified group legal services plans should be extended.

Explanation of Provision

Under the Act, the favorable tax treatment for qualified group legal services plans is extended to apply to taxable years ending before January 1, 1985.

Effective Date

The provision is effective on enactment of the Act (August 13, 1981).

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $16 million in 1982, $24 million in 1983, $26 million in 1984, and $8 million in 1985.

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*For legislative background of this provision, see: Senate floor amendment, 127 Cong. Rec. S8260-61 (daily ed. July 23, 1981); and H. Rep. No. 97-215 (August 1, 1981), p. 246 (Joint Explanatory Statement of the Committee of Conference).

B. Tax-Exempt Obligations

1. Obligations issued for the purchase of mass transit equipment (sec. 811 of the Act and sec. 103(b) of the Code)*

Prior Law

Under section 103, interest on State and local government obligations generally is exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial development bonds, with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business not carried on by a State or local government or tax-exempt organization and (2) payment of principal or interest is secured, in whole or in major part, by an interest in, or derived from payments with respect to, property used in a trade or business.

Interest on certain industrial development bonds qualifies for tax exemption if the proceeds of the bonds are used to provide exempt activity facilities. Such facilities include mass commuting facilities, such as terminals. Under prior law, these facilities did not include the equipment used for commuting purposes, such as buses, subway cars, or railroad passenger cars used in a commuting system.

Reasons for Change

A State or local government unit, such as a mass transit authority, could issue tax-exempt bonds to finance the acquisition of mass commuting vehicles which it owned directly. However, because tax-exempt industrial development bonds could not be issued for mass commuting vehicles under prior law, it was not possible for a State or local government to issue tax-exempt obligations to finance mass commuting vehicles that would be leased from a nonexempt person to the State or local governmental unit for use in providing mass transit services to the general public. If such transactions were permitted, the nonexempt lessor would be allowed certain tax benefits, such as depreciation deductions, all or a portion of which could be flowed through to the State or local government in the form of lower lease payments. The Congress believed that these types of arrangements should be permitted in the case of mass transit vehicles because of the financial stress from high interest rates and equipment costs placed on State and local governments in providing mass transit services.

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*For legislative background of the provision, see: H.R. 4242, as reported by the House Ways and Means Committee, sec. 803; H. Rep. No. 97-201 (July 24, 1981), pp. 269-270; H.R. 4242, as passed by the House (July 29, 1981), sec. 803; and H. Rep. No. 97-215 (August 1, 1981), pp. 269-270 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

The Act provides that interest on obligations of a State or local government is exempt from Federal income tax if substantially all of the proceeds of the obligations are used to provide qualified mass commuting vehicles. The Act defines such vehicles to mean any bus, subway car, rail car, or similar equipment which is leased to a mass transit system that is wholly owned by one or more governmental units (or agencies or instrumentalities of such units) and that is principally used by the mass transit system in providing mass commuting services to the general public.

Effective Date

The authority to issue bonds under the provision is in effect from the date of enactment of the Act through December 31, 1984.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $1 million in 1982, $7 million in 1983, $29 million in 1984, $54 million in 1985, and $64 million in 1986.

2. Obligations of certain volunteer fire departments (sec. 812 of the Act and sec. 103 of the Code)*

Prior Law

In general, both present law and prior law exclude from gross income interest on obligations of a State or of its political subdivisions (sec. 103(a)(1)). Prior law did not contain a specific exclusion for interest on obligations of volunteer fire departments.

Under Treasury regulations, the term "political subdivision" includes any division of a State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit (Reg. § 1.103-1(b)). Three generally acknowledged sovereign powers of States are the power to tax, the power of eminent domain, and the police power.[1]

Present Treasury regulations treat obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations as the obligations of such a unit (Reg. § 1.103-1(b)). Several requirements must be satisfied in order for an issuer to qualify as a constituted authority of a State or local governmental unit (See Rev. Rul. 57-187, 1957-1 C.B. 65; Rev. Rul. 63-20, 1963-1 C.B. 26; and Prop. Treas. Reg. § 1.103-1(c)(2)).[2]

In an early ruling,[3] the Internal Revenue Service ruled that interest received on certificates of indebtedness, known as "fire relief certificates," issued in the State of Minnesota constituted interest on the obligations of a State and, therefore, was not taxable. In another early ruling,[4] the Revenue Service held that interest on fire district bonds issued by a political subdivision of a State and assumed by a private corporation (without releasing the municipality from liability) was exempt from taxation.

The U.S. Tax Court has held that certain volunteer fire departments (in Pennsylvania, West Virginia, Delaware, Maryland, and Kentucky) were not political subdivisions of the States in which they were located and, hence, that interest on their obligations was

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8338-40 (daily ed. July 24, 1981); H.R. 4242, as reported by the House and Ways and Means Committee, sec. 811; H. Rep. No. 97-201 (July 24, 1981), pp. 271-273; H.R. 4242, as passed by the House (July 29, 1981), sec. 809; and H. Rep. No. 97-215 (August 1, 1981), p. 270 (Joint Explanatory Statement of the Committee of Conference).

[1] See, e.g., *Estate of Alexander J. Shamberg,* 3 T.C. 131, aff'd 144 F. 2d 998 (2d Cir.), cert. den. 323 U.S. 792 (1944).

[2] In general, the proposed regulations provide that these requirements are satisfied if: (1) the authority is specifically authorized pursuant to State law to issue obligations to accomplish public purposes of the unit; (2) the unit controls the governing board of the authority; (3) the unit has either organizational control over the authority or supervisory control over the activities of the authority; (4) any net earnings of the authority (beyond that necessary for retirement of the indebtedness or to implement the public purposes or program of the unit) may not inure to the benefit of any person other than the unit; (5) upon dissolution of the authority, title to all property owned by the authority will vest in the unit; and (6) the authority is created and operated solely to accomplish one or more of the public purposes of the unit specified in the authorization for the unit.

[3] O.D. 30, 1 C.B. 83, declared obsolete, Rev. Rul. 69-31, 1969-1, C.B. 307.

[4] S.M. 2670, III-2 C.B. 80, declared obsolete, Rev. Rul. 69-31, 1969-1 C.B. 307.

not exempt from tax under section 103(a)(1) (*Seagrave Corporation*, 38 T. C. 247 (1962)). The rationale for this holding was that the volunteer fire departments involved were not created by any special statutes and received no delegation of State power.

Reasons for Change

The Congress was concerned with the tax treatment of obligations of volunteer fire departments under prior law. It was believed that, given the proper conditions, volunteer fire departments should have the same ability as municipal fire departments to borrow money at tax-exempt interest rates. Thus, the Congress decided to treat the obligations of certain volunteer fire departments as the obligations of political subdivisions for certain limited purposes.

Explanation of Provision

Under the Act, an obligation of a volunteer fire department is treated as an obligation of a political subdivision of a State if the department is a qualified volunteer fire department with respect to an area within the jurisdiction of such political subdivision, and the obligation is issued as part of an issue substantially all the proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of a firehouse or firetruck used or to be used by the fire department.

In order for a volunteer fire department to qualify under this provision and, therefore, to have the interest on certain of its obligations qualify for tax exemption, it must meet two requirements. First, the fire department must be organized and operated to provide firefighting or emergency medical services for persons in an area that is not provided with any other firefighting services. Second, the fire department must be required to furnish those services pursuant to a written agreement between it and the political subdivision.

Effective Date

The provision applies to obligations of qualified volunteer fire departments issued after December 31, 1980. In addition, the provision has retroactive effect with respect to certain obligations held by the First Bank and Trust Company of Indianapolis, Indiana, which were issued after December 31, 1969, and before January 1, 1981.[5]

Revenue Effect

The provision is estimated to reduce budget receipts by less than $1 million annually.

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[5] Bonds which qualify for retroactive applicability of the provision are bonds issued by a qualified volunteer fire department, after December 31, 1969, and before January 1, 1981, to the First Bank and Trust Company of Indianapolis, Indiana, for the acquisition, construction, reconstruction, or improvement of firefighting property. Firefighting property, for this purpose, is depreciable property that is either (1) used in the training for the performance of, or in the performance of, firefighting or ambulance services or (2) used exclusively to house such property. An obligation so described qualifies under the provision only for the period during which it is held by the First Bank and Trust Company of Indianapolis, Indiana.

C. Excise Taxes

1. Extension of telephone excise tax (sec. 821 of the Act and sec. 4251 of the Code)*

Prior Law

The Federal excise tax imposed on communications services (local telephone, toll telephone, and teletypewriter services) for 1981 is two percent of amounts paid for services (sec. 4251). Under prior law, the tax was scheduled to be reduced to one percent for 1982 and to expire as of January 1, 1983.

Reasons for Change

The Congress decided that it was appropriate to extend the telephone excise tax at one percent for two years.

Explanation of Provision

The Act extends the Federal telephone excise tax for 1983 and 1984 at a one-percent rate. The tax is scheduled to expire as of January 1, 1985.

Effective Date

The provision is effective for calendar years 1983 and 1984.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $435 million in 1983, $766 million in 1984, and $309 million in 1985.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8242-50 (daily ed. July 23, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 273 (Joint Explanatory Statement of the Committee of Conference).

2. Unemployment tax status of certain fishing boat services (sec. 822 of the Act and sec. 3306(c) of the Code)*

Prior Law

Services performed by members of the crew on boats engaged in catching fish or other forms of aquatic animal life are exempt from the tax imposed by the Federal Insurance Contributions Act (FICA) if their remuneration is a share of the boat's catch (or cash proceeds from the sale of a share of the catch) and if the crew of such boat normally is made up of fewer than ten individuals (sec. 3121(b)(20)). In the case of an operation involving more than one boat, the exemption applies if the remuneration is a share of the entire fleet's catch or its proceeds, and if the operating crew of each boat in the fleet normally is made up of fewer than ten individuals.

In addition, the remuneration received by those fishing boat crew members whose services are exempt for purposes of FICA is not considered to be "wages" for purposes of income tax withholding (sec. 3401(a)(17)), and those individuals are considered to be self-employed for purposes of the Self-Employment Contributions Act (sec. 1402(c)(2)(F)).

However, under prior law, the employer of fishing boat crew members whose services were exempt for purposes of FICA, and whose remuneration was not subject to income tax withholding, was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons.

Reasons for Change

The Congress believed that, from the standpoint of simplicity and administrative convenience for fishing boat owners, fishing boat crew members who are treated as self-employed for purposes of social security and income tax withholding also should be treated as self-employed for purposes of the unemployment tax provisions. However, in order to determine the best long-term solution to this problem, as well as to make certain that no fishing boat crew members will be adversely affected, the Congress decided to make this provision effective only for a one-year period.

Explanation of Provision

The Act provides that wages paid during 1981 to fishing boat crew members who are self-employed for purposes of FICA are not subject to FUTA taxes.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7848-49 (daily ed. July 17, 1981), and H. Rep. No. 97-215 (August 1, 1981), pp. 271-272 (Joint Explanatory Statement of the Committee of Conference).

Thus, in the case of 1981 wages, services by fishing boat crew members engaged in catching fish or other forms of aquatic animal life are exempt for purposes of FUTA if the remuneration for those services is a share of the boat's catch or of the proceeds of the catch and if the crew of such boat normally is made up of fewer than ten individuals. If a fishing operation involves more than one boat, services are exempt for purposes of FUTA if the remuneration for services is a share of the entire fleet's catch or its proceeds, and if the operating crew of each boat in the fleet normally is made up of fewer than ten individuals.

Effective Date

The provision applies to remuneration paid during 1981.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by less than $1 million in 1982.

3. Payout requirement of private foundations (sec. 823 of the Act and sec. 4942 of the Code)*

Under prior law, a private foundation was required to distribute currently, for its charitable or other exempt purposes, the greater of its adjusted net income or five percent of the value of its investment assets (called the "minimum investment return").[1] This minimum distribution requirement for a taxable year generally must be met by making the required amount of charitable distributions in that taxable year or in the following taxable year. Graduated sanctions are imposed in the event of failure to distribute the required minimum amount (sec. 4942).

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

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

Reasons for Change

The rate of return that assets generally earn represents a real income portion and a portion to compensate for the effects of inflation. The minimum payout requirement of prior law required that a private foundation distribute the entire amount of its nominal income even though a portion of that income was to compensate the foundation for the effects of inflation. As a result, the effect of the minimum payout requirement of prior law was gradu-

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8280-83 (daily ed. July 23, 1981), and H. Rep. No. 97-215 (August 1, 1981), p. 281 (Joint Explanatory Statement of the Committee of Conference).

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

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

ally to reduce the real value of a private foundation's investment assets.

The minimum payout requirement of prior law was adopted by the Congress when the rate of inflation was low compared with recent rates and, consequently, the effect of the minimum payout requirement was relatively minor. However, recent high rates of inflation have resulted in significant erosions of the real value of foundation endowments.

While the Congress believed that private foundations should only be required to distribute their real income for charitable purposes, the computation of such real income would be difficult. The Congress also was concerned that modification of the minimum payout rule to require payment of real income could have a substantial adverse effect upon the charitable recipients of grants from private foundations. Accordingly, the Congress concluded that private foundations need only be required to distribute their minimum investment return. The Congress believed that the distribution rule will provide substantial relief to private foundations from the effects of inflation without, in the long term, adverse consequences to the charitable recipients of foundation grants.

Explanation of Provision

The Act repeals the alternative requirement that, under prior law, required a private foundation to distribute any excess of adjusted net income over the minimum investment return. Under the payout rule as amended by the Act, a private foundation is required to make charitable distributions equal to five percent of its net investment assets, without regard to the amount of its income for the year.

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

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to reduce budget receipts by less than $5 million annually.

D. Other Provisions

1. Technical amendments relating to dispositions of investments in U.S. real property (sec. 831 of the Act and sec. 897 of the Code)*

Prior Law

The Omnibus Reconciliation Act of 1980 (P.L. 96-499), which passed the Congress on November 26, 1980, included a provision that foreign persons who dispose of U.S. real estate after June 18, 1980, are subject to United States taxation on such disposition. Also, foreign persons disposing of stock in a U.S. corporation having 50 percent or more of its gross asset value comprised of U.S. real property interests are subject to U.S. taxation. Further, distributions (liquidating or nonliquidating) of U.S. real property interests by a foreign corporation are subject to tax.

While this provision was effective for dispositions after June 18, 1980, special rules applied to transactions covered by a treaty of the United States. In general, the Code provision is to override treaties, but not until January 1, 1985. If existing treaties are renegotiated and signed before 1985, the old treaty is to take precedence over the Code provision for a maximum period of two years after the new treaty is signed.

Reasons for Change

The Congress was concerned that the provisions of the law intended to tax gain from the disposition by foreign investors of interests in U.S. real estate were being avoided. It appeared that the law was unclear in certain respects and that some taxpayers were taking positions that were inconsistent with Congressional intent. Accordingly, the Congress believed that it should clarify those provisions of the law which were unclear.

Also, certain technical problems that resulted in unintended adverse tax consequences had been brought to the attention of the Congress. The Congress believed that in order to insure that the provisions worked equitably these technical problems should be corrected.

Explanation of Provision

Overview

The provisions of the Act make a number of clarifying and technical amendments to the rules enacted in 1980 dealing with foreign investment in U.S. real property. These provisions are in-

*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S8472-75 (daily ed. July 27, 1981) and S8583-85 (daily ed. July 28, 1981), and H. Rep. No. 97-215 (August 1, 1981), pp. 274-281 (Joint Explanatory Statement of the Committee of Conference).

tended to make clear the intent of the Congress to tax dispositions of U.S. real property interests by foreign investors.

Code section 897 provides for the override of certain nonrecognition provisions of the Code, and for the continued application of treaties until 1985. However, it was not the intent of the Congress that these provisions could be manipulated so as to make the provisions of the legislation, in effect, elective until 1985. Accordingly, in the Act the Congress reiterates its intent to collect at least one tax on the transfer of U.S. real property interests by foreign investors.

The Congress provided a grace period of tax exemption until January 1, 1985, to certain foreign investors who were residents of a treaty country on the date section 897 became effective. However, it was not the intent of the Congress to grant such an exemption to a foreign investor who after the enactment of section 897 rearranged his investment so as to come under a treaty which would exempt the gain from U.S. tax. While most, if not all, of these transactions are already covered by the present statute because of the great latitude given to the Treasury Department to prescribe regulations to prevent tax avoidance, the Congress decided that clarification of these provisions will help avoid any misunderstandings.

Virgin Islands corporations

Gains realized by foreign investors on the sale of U.S. real property are subject to U.S. tax unless the property is held by a Virgin Islands corporation. This arises because section 28(a) of the Revised Organic Act of the Virgin Islands provides that Virgin Islands corporations satisfy their U.S. income tax obligations by paying their tax on worldwide income to the Virgin Islands under the so-called "mirror system." As interpreted by the courts and the Internal Revenue Service, the mirror system means that the name "Virgin Islands" is substituted for the name "United States," and vice versa, wherever such names appear in the U.S. income tax laws.

For purposes of the Virgin Islands mirror tax, a Virgin Islands corporation is a domestic corporation. Some taxpayers have argued that such a corporation could avoid tax on its capital gains if it sells its U.S. real estate and liquidates under the rules prescribed by section 337. It has been argued that gains realized by the foreign shareholders also escape Virgin Islands tax, since section 897, as mirrored, can be read to impose a Virgin Islands tax on gain from a disposition of a Virgin Islands real property interest, but there is no Virgin Islands tax on the sale of a U.S. real property interest. It has also been argued that various other transactions involving foreign corporations interacting with the mirror system avoid the effect of the real estate legislation. This situation does not exist for the other possessions of the United States.

The Act provides that a U.S. real property interest includes an interest in real property located in the United States or the Virgin Islands. Under this definition, a foreign shareholder of a Virgin Islands corporation 50 percent or more of the gross asset value of which consists of Virgin Islands or U.S. real property interests is

subject to tax on the gain from the disposition of his interest in that Virgin Islands real property holding corporation.

Thus, for example, this provision makes it clear that if at least half of the assets of a Virgin Islands corporation are U.S. or Virgin Islands real estate, its shareholders are subject to Virgin Islands taxation under mirror section 897(a) on any gain on the disposition of stock in the corporation: Likewise, if at least half of the assets of a Virgin Islands corporation are U.S. real estate, and the corporation adopts a plan of complete liquidation and then sells the real estate pursuant to that plan, the corporation will be subject to U.S. taxation on the gain from the sale. As a further example, the provision also makes clear that a foreign corporation may not avoid the provisions of section 897 by establishing a permanent establishment in the Virgin Islands for investment in U.S. real property.

To prevent double taxation, the Act provides that a person subject to tax because of section 897 shall pay such tax and file the necessary returns with the United States with respect to real property interests where the underlying interest in real property is located in the United States, and with the Virgin Islands with respect to a real property interest where the underlying interest in real property is located in the Virgin Islands. A sale of an interest, other than solely as a creditor, in a U.S. real property holding corporation is subject to tax in the United States, while the tax on a sale of an interest in a Virgin Islands real property holding corporation is payable to the Virgin Islands.

The source rules are amended to provide that gain on the disposition of an interest in real property located in the Virgin Islands is foreign source income to United States taxpayers. Thus, gain upon the disposition of an interest in real property located in the Virgin Islands will be taxed as income that is effectively connected with the conduct of a trade or business in the Virgin Islands. Further, this provision insures that a U.S. person subject to Virgin Islands tax on the disposition of Virgin Islands property may take a foreign tax credit against his U.S. liability for such tax.

Partnership assets

Tax is imposed on gain realized on the disposition of an interest in a U.S. real property holding corporation, which is a U.S. corporation 50 percent or more of the fair market value of the assets of which consists of U.S. real property interest. Under prior law, if a corporation is a partner, only the U.S. real property of the partnership, and not the other assets of the partnership, is taken into account for purposes of determining whether a corporation is a U.S. real property holding corporation. Assume, for example, that X Corporation owns non-real estate assets with a fair market value of $500 and also has a 50 percent interest in partnership A, and that the assets of partnership A consist of U.S. real estate having a fair market value of $2,000 and other assets which are not U.S. real property interests estate having a fair market value of $4,000. Under prior law, X would have been treated as owning a proportionate share of only the U.S. real property of the partnership. Accordingly, X would have been treated as owning U.S. real estate with a fair market value of $1,000 (50 percent of $2,000). According-

ly, X would have been a U.S. real property holding corporation because more than 50 percent of the fair market value of its assets consisted of U.S. real property interests.

The Act changed prior law to provide that for purposes of determining whether a corporation is a U.S. real property holding corporation, the corporate partner takes into account its proportionate share of all assets of the partnership. Thus, for example, the corporate partner counts its proportionate share of the foreign real estate of the partnership. The same rules apply to trusts and estates in which a corporation has an interest. The provision also makes clear that the same rules apply to a chain of successive partnerships, trusts, or estates. In the example above, under the law as amended by the Act, X Corporation would be considered to own 50 percent of all of the assets of partnership A, rather than just its U.S. real estate. Thus, the fair market value of its U.S. real property interests would continue to be $1,000, but it would now be considered to have total assets with a fair market value of $3,500 (50 percent of A's U.S. real estate or $1,000, plus 50 percent of A's other assets or $2,000 plus $500 of the assets X owns directly). Accordingly, X would not be a U.S. real property holding corporation because less than 50 percent of the fair market value of its assets consists of U.S. property interests.

Taxation in carryover basis cases

FIRPTA provides that a foreign corporation recognizes gain on the distribution (including a distribution in liquidation or redemption) of a U.S. real property interest. However, a foreign corporation will not be subject to tax on the distribution of a U.S. real property interest if the adjusted basis of the distributed property in the hands of the distributee is the same as the adjusted basis of the property before distribution increased by the amount of any gain recognized by the distributing corporation (that is, in a carryover basis situation). FIRPTA also provides that the nonrecognition provisions of the Code generally do not apply to dispositions of a U.S. real property interest unless that interest is exchanged for an interest the sale of which would be subject to taxation under the Code. Under FIRPTA, the Treasury Department can, by regulation, relieve a foreign corporation from tax or subject it to tax where property is disposed of in a nonrecognition transaction.

The Act clarifies FIRPTA as it applies to certain distributions by a foreign corporation. It specifically provides that gain on the distribution by a foreign corporation of a U.S. real property interest in a carryover basis situation will be taxed to the distributing corporation unless, at the time of the receipt of the distributed property, the distributee would be subject to U.S. income taxation under the Code (as modified pursuant to section 894 by treaty) on the later disposition of the property, or the Treasury Department provides for nonrecognition in its regulations.

The Act thus makes clear the Treasury's authority under FIRPTA to provide for recognition of gain where a carryover basis transaction is entered into for the purpose of avoiding Federal income tax on the transaction.

The Treasury may, waive taxation in appropriate cases where tax avoidance is not present.

For example, assume that A, a nonresident alien individual, owns U.S. real estate through corporation B organized in country X. A contributes the stock of B to corporation C which is located in country Y. Y has a treaty with the U.S. that exempts individual and corporate residents of Y from U.S. tax on gain from the sale of U.S. real estate. B liquidates under Code section 332. Since the present treaty between Y and the United States enables C to dispose of the property free of U.S. tax, B is taxed on the distribution to the extent the fair market value of the property at the time of the distribution exceeds B's adjusted basis in the property.

Nondiscrimination

U.S. income tax treaties generally contain a provision that provides for nondiscriminatory tax treatment by the treaty partners of U.S. residents and residents of the treaty partner. A similar provision is contained in some friendship, commerce, and navigation treaties.

The effective date of FIRPTA is generally delayed until 1985 to the extent that any of its provisions conflict with a U.S. treaty obligation (including the treaty nondiscrimination provisions). Thereafter, the provisions of FIRPTA supersede any inconsistent treaty provisions.

A potential for conflict with U.S. treaty nondiscrimination provisions exists because the system employed by FIRPTA to tax foreign investors holding U.S. real estate indirectly through foreign corporations is different than that used where the investment vehicle is a U.S. corporation. Where a foreign investor invests through a U.S. Real Property Holding Company (RPHC), the U.S. corporation is permitted to dispose of the U.S. real estate in liquidation or in reorganization without recognition of gain pursuant to the regular nonrecognition provisions applicable to U.S. corporations, but the foreign investor is taxable on disposition of his stock in the U.S. RPHC. In the case of an investment indirectly made through a foreign corporation, no tax is imposed on the foreign investor on the disposition of stock in the foreign corporation (even if all its assets consist of U.S. real estate) but the regular nonrecognition rules generally do not apply to transfers or distributions of U.S. real property interests by the foreign corporation where the transaction would otherwise permit the transferee to dispose of the property without tax. Notwithstanding the generally more favorable treatment afforded indirect investments through foreign corporations when the treatment of both the foreign investor and the corporation are taken into account, the argument can be made that the treaty provisions require that discrimination should be measured at the corporate level without regard to the differences in treatment at the shareholder level. From that perspective, the failure to allow foreign corporations the same nonrecognition treatment available to U.S. corporations would be discriminatory even though foreign shareholders of U.S. RPHCs would be taxable on the disposition of their stock (or the receipt of the U.S. real property in liquidation) while foreign shareholders of foreign corporations holding U.S. real estate would not.

In order to avoid claims that the legislation conflicted with the treaty nondiscrimination provisions, FIRPTA allows foreign corpo-

rations that have permanent establishments in the United States to elect to be treated as domestic corporations (sec. 897(i) of the Code). The election was allowed only if, under a treaty, the permanent establishment could not be treated less favorably than domestic corporations carrying on the same activities. Despite this provision, certain taxpayers had argued that, because of technical problems, they could not make the election and therefore they were still being discriminated against.

The Act amends section 897(i) to provide that any foreign corporation may make an election to be treated as a domestic corporation for purposes of section 897 and the related reporting requirements if the corporation owns a U.S. real property interest and, under any treaty obligation of the United States, the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest.

The election may be revoked only with the consent of the Treasury Department. The election may be made only if all owners of all classes of interests of the corporation (other than interests solely as a creditor) at the time of the election consent to the election and agree that any gain from the disposition of an interest after June 18, 1980 (the effective date of the original legislation) which would be taken into account under the legislation if the elective corporation were a U.S. corporation will be taxable even if such taxation would not be allowed under a treaty to which the United States is a party. If a class of interest is traded on an established securities market, then the consent need only be made by a person who held more than five percent of that class of interest.

As under the prior law, the election is also subject to such other conditions as the Treasury may prescribe with respect to the electing corporation and its shareholders.

The Act also makes clear that the election provided by this provision is the exclusive remedy under existing treaties or under those that may be negotiated or renegotiated in the future for any person claiming discriminatory treatment because of section 897, or section 6039(c), or both.

Indirect holdings

Under prior law, a question had arisen as to the obligation of a foreign entity to report an interest in U.S. real estate if the foreign entity owned stock of a foreign corporation that in turn owned stock of a U.S. real property holding corporation.

The Act makes clear that for purposes of determining whether a foreign corporation or a partnership, trust or estate has substantial U.S. real property investors, and therefore must report, the foreign entity must look through to the assets of any U.S. corporations in which the foreign entity has an interest.

Contributions to capital

Under prior law, an argument had been made that a foreign investor could avoid paying U.S. tax on gain from the disposition of a U.S. real property interest if he contributed that interest to the capital of a foreign corporation in which the investor is a shareholder and received nothing in exchange for the property. The Act clarifies prior law by providing specifically that gain is recognized

by a nonresident alien individual or foreign corporation on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid in surplus or as a contribution to capital. In such a case, gain is recognized to the extent of the fair market value of the property transferred over the adjusted basis and any other gain recognized by the transferor.

Liquidation of foreign corporations

A foreign corporation is taxed when it sells or exchanges a U.S. real property interest, even if the sale would otherwise be tax free under the nonrecognition liquidation provisions of the Code. Under the legislation as reported by the Senate Finance Committee on December 15, 1979, and the House Ways and Means Committee on June 18, 1980, a foreign corporation could have taken advantage of the tax-free liquidation provisions, but the foreign shareholders would have been taxed on the exchange of their stock, which was a real property interest, for the property distributed.

In the case of a U.S. person acquiring the stock of a foreign corporation from a foreign person between December 15, 1979, and November 26, 1980, it would have been reasonable to assume that the tax, if any, due with respect to the unrealized appreciation of the U.S. real estate would have been borne by the foreign seller of the corporation's stock. The conference action shifted that burden to the liquidating corporation—effectively the acquiring shareholders. Thus, in the case of an acquiring U.S. corporation, it now owns the stock of a foreign corporation that has a substantial tax liability due on its U.S. real estate. In contrast, if the U.S. corporation had acquired the stock of a U.S. corporation, it could have liquidated the corporation without a tax liability and received a step-up in basis of the U.S. real estate to its fair market value.

The Act permits foreign corporations that were acquired during the period that began after December 31, 1979, and before November 26, 1980, to elect to be treated as a U.S. corporation for purposes of liquidating under section 334(b)(2). This enables those corporations to liquidate tax-free with a corresponding step-up in basis of the U.S. real estate in the hands of the U.S. purchaser corporation.

For all other purposes, the foreign corporation is treated as a foreign corporation. Thus, the selling foreign shareholders are treated as having sold the stock of a foreign corporation and, accordingly, generally are not taxable by the United States.

A separate problem arises in situations where a U.S. individual has held stock of a foreign corporation which holds U.S. real estate. Under prior law, on a 12-month liquidation of the foreign corporation, there would be a tax at the corporate level on the U.S. real property interest, as well as a tax at the shareholder level. If the acquired corporation had been a U.S. corporation, the liquidation could have been accomplished tax-free at the corporate level with a tax remaining at the shareholder level. The double tax in the case of U.S. shareholders of foreign corporations was not intended.

This relieves the double tax burden by giving U.S. shareholders who acquired their interests prior to the effective date of the 1980 legislation a credit against any tax imposed on them on the surrender of their stock in the liquidating foreign corporation. The credit

is equal to the tax imposed on the liquidating foreign corporation on the sale of the U.S. real property. This rule applies only if the U.S. persons continuously held the stock since June 18, 1980, the effective date of that legislation.

Application of treaties

The 1980 statute provided that existing treaties will take precedence over the real estate legislation until January 1, 1985. However, if a new treaty is negotiated to resolve conflicts with this legislation, the provisions of the old treaty will apply for a maximum period of two years after the new treaty is signed. However, if the new treaty is ratified earlier, the period may be shorter. The effect of this effective date provision on treaties with countries with which the United States signed a treaty was unclear.

The Act makes clear that, in order for a new treaty to begin the two-year period, it must have been signed on or after January 1, 1981, and before January 1, 1985. It also makes clear that the old treaty with that country will take precedence over the legislation for two years after the new treaty is signed, even if that two-year period ends after December 31, 1984, unless the new treaty is ratified earlier. If a new treaty was signed before January 1, 1981, the old treaty will continue to apply until December 31, 1984, or, if earlier, until the new treaty is ratified.

Effective Date

The provision applies to dispositions after June 18, 1980, in taxable years ending after such date.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

2. Modification of foreign investment company rules (sec. 832 of the Act and sec. 1246 of the Code)*

Prior Law

Gain on the sale or exchange of stock in a foreign investment company is taxed as ordinary income to the extent attributable to earnings and profits derived after 1962. Under prior law, once a foreign corporation became a foreign investment company, ordinary income treatment applied, under prior law, even to earnings and profits derived before the foreign corporation became a foreign investment company.

Under Code section 1248, certain gain attributable to post-1962 earnings and profits derived by a controlled foreign corporation is treated as a dividend. Gain attributable to earnings and profits of a foreign corporation which were accumulated during any taxable year beginning before January 1, 1976, while the corporation was a less developed country corporation under section 902(b) as in effect before the enactment of the Tax Reduction Act of 1976, are taxed as capital gain, rather than as a dividend under sec. 1248(d)(3).

Reasons for Change

The Congress believed that the purpose of preventing taxpayers from avoiding the rules for domestic investment companies by operating offshore investment vehicles could be achieved by requiring recharacterization of gain on disposition of shares of such companies only to extent of earnings and profits accumulated after a corporation first qualified as a foreign investment company under the asset test. The more extensive recharacterization of gain on disposition provided for under prior law would only impose an unintended hardship on inadvertent investment companies.

Explanation of Provision

The Act provides that gain on the disposition of stock in a foreign investment company attributable to earnings and profits derived before the foreign corporation first became a foreign investment company is not subject to tax under section 1246. Instead, that gain not covered by section 1246 because of the provision is covered by section 1248 where that section is otherwise applicable. The provision only applies to a company that became a foreign investment company because it met the requirements of section 1246(b)(2), that is because it was engaged primarily in the business of investing, reinvesting, or trading in securities at a time when more than 50 percent of the total value of its stock was held (directly or indirectly) by U.S. persons.

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*For legislative background of the provision, see: Senate floor amendment, 127 Cong. Rec. S7772-73 (daily ed. July 16, 1981), and H. Rep. No. 97-215 (August 1, 1981), pp. 270-271 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision is effective on enactment of the Act (August 13, 1981).

Revenue Effect

This provision is estimated to reduce budget receipts by less than $5 million annually.

V. REVENUE EFFECTS OF THE ACT

The estimated revenue effects of the tax provisions of the Act are presented in tables in this part of the General Explanation. Tables V-1 and V-2 below summarize the effects of the Act on budget receipts for fiscal years 1981 through 1986 and on tax liability for calendar years 1981 through 1986, respectively. Table V-3 shows in more detail the revenue effects on fiscal year budget receipts. Table V-4 shows in more detail the revenue effects on calendar year tax liabilities.

As shown in Table V-1, the Act provides tax receipt reductions totalling $1.6 billion in fiscal year 1981, $37.7 billion in fiscal year 1982, $92.7 billion in fiscal year 1983, and $267.7 in fiscal year 1986. On the calendar year basis (Table V-2), the tax liability reductions total $9.0 billion in 1981, $58.4 billion in 1982, $117.7 billion in 1983, and $298.0 billion in 1986.

Additional data relating to individual tax reductions under the Act are presented in Tables IV-1 through IV-4 set forth in Part I-A-1 of the General Explanation, *supra*. Table IV-1 reflects the distribution of the three-year cut in individual income taxes by income class for 1982, 1983, and 1984. Tables IV-2, IV-3, and IV-4 above set forth comparative data on Federal income tax burdens on individuals at various income levels under the prior law and under the Act, showing the reduction in tax burdens on individuals resulting from the Act, for 1982, 1983, and 1984, respectively.

The estimates shown here are the same as those used in the Conference Report on H.R. 4242. Although most of the figures would not change if the revenue effects of the provisions in the Act were reestimated, in some cases estimates made now would differ from those in the report because additional information has become available.

Table V-1.—Summary of Estimated Revenue Effects of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title I.—Individual income tax provisions	−39	−26,947	−71,112	−114,700	−148,254	−196,162
Title II.—Business incentive provisions	−1,563	−10,727	−18,746	−28,436	−39,448	−54,665
Title III.—Savings provisions		−247	−1,797	−4,207	−5,629	−8,485
Title IV.—Estate and gift tax provisions		−204	−2,114	−3,218	−4,248	−5,568
Title V.—Tax straddles	37	623	327	273	249	229
Title VI.—Energy provisions		−1,320	−1,742	−2,242	−2,837	−3,619
Title VII.—Administrative provisions		1,182	2,048	1,856	718	592
Title VIII.—Miscellaneous provisons		−16	404	711	247	−64
Total Revenue Effect	**−1,565**	**−37,656**	**−92,732**	**−149,963**	**−199,202**	**−267,742**

Table V-2.—Summary of Estimated Revenue Effects of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title I.—Individual income tax provisions	−4,070	−41,879	−85,340	−120,150	−164,482	−215,434
Title II.—Business incentive provisions	−5,926	−13,883	−24,425	−33,113	−46,636	−63,791
Title III.—Savings provisions	−20	−869	−3,943	−3,791	−8,101	−8,964
Title IV.—Estate and gift tax provisions	−18	−2,133	−3,231	−4,271	−5,589	−6,839
Title V.—Tax straddles	1,421	722	112	60	36	16
Title VI.—Energy provisions	−529	−1,043	−1,977	−2,348	−3,010	−3,877
Title VII.—Administrative provisions	122	705	473	823	426	951
Title VIII.—Miscellaneous provisions		−24	667	727	−64	−64
Total Revenue Effect	**−9,020**	**−58,404**	**−117,664**	**−162,063**	**−227,420**	**−298,002**

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title I.—Individual income tax provisions:						
Sec. 101.—Rate cuts; rate reduction credit [1]		−25,793	−65,703	−104,512	−122,652	−143,832
Sec. 102.—20-percent maximum rate on net capital gain for portion of 1981	−39	−355				
Sec. 103.—Deduction for two-earner married couples		−419	−4,418	−9,090	−10,973	−12,624
Sec. 104.—Indexing					−12,941	−35,848
Secs. 111-115.—Partial exclusion for earned income from sources outside the U.S. and foreign housing costs, repeal of deduction for certain expenses of living abroad, and employees living in camps		−299	−544	−563	−618	−696
Sec. 121.—Deduction for charitable contributions for individuals who do not itemize deductions		−26	−189	−219	−681	−2,696
Sec. 122.—18-month period for rollover of principal residence increased to 2 years	[3]	[4]	[4]	[4]	[4]	[4]
Sec. 123.—One-time exclusion of gain increased to $125,000	[3]	−18	−53	−63	−76	−91
Sec. 124.—Increases in child and dependent care credit; exclusion of employer payments for dependent care assistance		−19	−191	−237	−296	−356

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 125.—Deduction for adoption expenses		−9	−9	−10	−11	−12
Sec. 126.—Maximum rate of imputed interest for sale of land between related persons	(3)	(2)	(2)	(2)	(2)	(2)
Sec. 127.—State legislators travel expenses		−9	−5	−6	−6	−7
Sec. 128.—Rates of tax for principal campaign committees	(2)	(2)	(2)	(2)	(2)	(2)
Total, individual tax provisions	**−39**	**−26,947**	**−71,112**	**−114,700**	**−148,254**	**−196,162**
Title II.—Business incentive provisions:						
Secs. 201-209, 211.—Accelerated cost recovery system and related provisions [5]	−1,503	−9,569	−16,796	−26,250	−37,285	−52,797
Secs. 212 and 214.—Increase in investment tax credit for qualified rehabilitation expenditures; allow investment tax credit for certain rehabilitated buildings leased to tax-exempt organizations or to governmental units	−9	−129	−208	−240	−304	−414
Sec. 213.—Investment credit for used property—increase in dollar limit	−24	−61	−74	−85	−137	−198
Sec. 221.—Credit for increasing research activities		−448	−708	−858	−847	−485

Footnotes are at end of table.

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 222.—Charitable contributions of scientific property used for research	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 223.—Suspension of regulations relating to allocation under section 861 of research and experimental expenditures		−57	−120	−62	(2)	
Sec. 231.—Reduction in corporate tax rates		−116	−365	−521	−565	−610
Sec. 232.—Increase in accumulated earnings credit		(2)	−33	−36	−40	−44
Secs. 233-234.—Subchapter S shareholders and treatment of trusts as subchapter S shareholders		(2)	(2)	(2)	(2)	(2)
Secs. 235-238.—Simplification of LIFO inventories and small business accounting		−68	−184	−192	−145	−64
Secs. 241-244.—Reorganizations involving financially troubled thrift institutions[6]	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 245.—Mutual savings banks with capital stock	−5	−10	−12	−18	−22	−25
Secs. 251-252.—Stock options and certain property transfers	(2)	(2)	(2)	(2)	11	21
Sec. 261.—Adjustments to new jobs tax credit		−63	−13	57	117	161

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 262.—Section 189 made inapplicable to low-income housing		−14	−33	−27	−23	−21
Sec. 263.—Increase in deduction allowable to a corporation in any taxable year for charitable contributions		−44	−93	−102	−112	−123
Sec. 264.—Amortization of low-income housing	−1	−8	−16	−25	−35	−39
Sec. 265.—Deductibility of gifts by employers to employees		−4	−5	−6	−7	−9
Sec. 266.—Deduction for motor carrier operating authority [7]	−21	−121	−71	−71	−54	−18
Sec. 267.—Limitation on additions to bank loss reserves		−15	−15			
Total, business incentive provisions	**−1,563**	**−10,727**	**−18,746**	**−28,436**	**−39,448**	**−54,665**
Title III.—Savings provisions: [8]						
Sec. 301.—Exclusion of interest on certain savings certificates		−398	−1,791	−1,142		
Sec. 302.—Repeal of $200 exclusion of interest; 15-percent net interest exclusion		566	1,916		−1,124	−3,126
Sec. 311.—Retirement savings		−229	−1,339	−1,849	−2,325	−2,582
Sec. 312.—Increase in amount of self-employed retirement plan deduction		−56	−157	−173	−183	−201

Footnotes are at end of table.

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 313.—Rollovers under bond purchase plans		(3)	(3)	(3)	(3)	(3)
Sec. 314.—Miscellaneous provisions		(3)	(3)	(3)	(3)	(3)
Sec. 321.—Reinvestment of dividends in the stock of public utilities		−130	−365	−416	−449	−278
Secs. 331-339.—Employee stock ownership plans and related provisions		(2)	−61	−627	−1,548	−2,298
Total, savings provisions		**−247**	**−1,797**	**−4,207**	**−5,629**	**−8,485**
Title IV.—Estate and gift tax provisions:						
Sec. 401.—Increase in unified credit		(2)	−1,077	−1,981	−2,811	−3,834
Sec. 402.—Reduction in maximum rates of tax		(2)	−172	−371	−556	−890
Sec. 403.—Unlimited marital deduction		(2)	−303	−304	−311	−300
Sec. 421.—Valuation of certain farm, etc., real property		−18	−280	−295	−326	−319
Sec. 422.—Coordination of extensions of time for payment of estate tax where estate consists largely of a closely held business		(2)	−20	−16	−15	−12
Sec. 423.—Treatment of certain contributions of works of art, etc		(2)	(2)	(2)	(2)	(2)

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 424.—Gifts made within 3 years of decedent's death not included in gross estate		(2)	−58	−50	−42	−38
Sec. 425.—Basis of certain appreciated property transferred to decedent by gift within one year of death		(9)	(9)	(9)	(9)	(9)
Sec. 426.—Disclaimers		(2)	(2)	(2)	(2)	(2)
Sec. 427.—Repeal of deduction for bequests, etc., to certain minor children		(9)	(9)	(9)	(9)	(9)
Sec. 428.—Postponement of generation-skipping tax effective date		(3)	(3)	(3)	(3)	(3)
Sec. 429.—Credit against estate tax for transfer to Smithsonian		(10)				
Sec. 441.—Increase in annual gift tax exclusion; unlimited exclusion for certain transfers		−123	−204	−201	−187	−175
Sec. 442.—Time for payment of gift taxes		−63	(2)	(2)	(2)	(2)
Total, estate and gift tax provisions		**−204**	**−2,114**	**−3,218**	**−4,248**	**−5,568**
Title V.—Tax Straddles:						
Secs. 501-509.—Tax straddles and related provisions [11]	**37**	**623**	**327**	**273**	**249**	**229**

Footnotes are at end of table.

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title VI.—Energy provisions:						
Sec. 601.—$2,500 royalty credit for 1981; exemption for 1982 and thereafter		−1,220	−947	−986	−1,193	−1,279
Sec. 602.—Reduction in tax imposed on newly discovered oil		−75	−255	−520	−867	−1,528
Sec. 603.—Exempt independent producer stripper well oil			−525	−721	−762	−797
Sec. 604.—Exemption from windfall profit tax of oil produced from interests held by or for the benefit of residential child care agencies		−25	−15	−15	−15	−15
Sec. 611.—Application of credit for producing natural gas from a nonconventional source with the Natural Gas Policy Act of 1978						
Total, energy provisions		**−1,320**	**−1,742**	**−2,242**	**−2,837**	**−3,619**
Title VII.—Administrative provisions:						
Sec. 701.—Prohibition of disclosure of methods for selection of tax returns for audits						
Sec. 711.—Changes in rate of interest for overpayments and underpayments		100	(2)	100	−100	60

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 721.—Changes in penalties for false information with respect to withholding		(9)	(9)	(9)	(9)	(9)
Sec. 722.—Additions to tax in the case of valuation overstatements; increase in negligence penalty		(3)	(3)	(3)	(3)	(3)
Sec. 723.—Changes in requirements relating to information returns		(3)	(3)	(3)	(3)	(3)
Sec. 724.—Penalty for overstated deposit claims		(3)	(3)	(3)	(3)	(3)
Sec. 725.—Declaration of estimated tax not required in certain cases		−44	−29	−38	−40	−38
Sec. 731.—Cash management—corporate estimated payments		614	1,522	1,190	201	−142
Sec. 741.—Increases in railroad retirement employer and employee taxes		512	555	604	657	712
Sec. 742.—Advance transfer of railroad retirement amounts payable under social security financial interchange						
Sec. 743.—Amendments to section 3231 clarifying definition of compensation		(3)	(3)	(3)	(3)	(3)
Sec. 751.—Fees for filing Tax Court petitions		(3)	(3)	(3)	(3)	(3)
Total, administrative provisions		**1,182**	**2,048**	**1,856**	**718**	**592**

Footnotes are at end of table.

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title VIII.—Miscellaneous provisions:						
Sec. 801.—Extension of moratorium on fringe benefit regulations						
Sec. 802.—3-year extension of exclusion for prepaid legal services		−16	−24	−26	−8	
Sec. 811.—Tax-exempt financing for vehicles used for mass commuting		(10)	−7	−29	−54	−64
Sec. 812.—Tax-exempt treatment of obligations of certain volunteer fire departments	(10)	(10)	(10)	(10)	(10)	(10)
Sec. 821.—2-year extension of extension of telephone excise tax at 1 percent			435	766	309	
Sec. 822.—Exclusion of certain services from Federal Unemployment Tax Act		(10)				
Sec. 823.—Private foundation distributions		(2)	(2)	(2)	(2)	(2)
Sec. 831.—Technical amendments relating to dispositions of investment in U.S. real property	(3)	(3)	(3)	(3)	(3)	(3)
Sec. 832.—Modification of foreign investment company provisions		(2)	(2)	(2)	(2)	(2)
Total, miscellaneous provisions	(10)	**−16**	**404**	**711**	**247**	**−64**

Table V-3.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Fiscal Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Grand Total, All Provisions	**−1,565**	**−37,656**	**−92,732**	**−149,963**	**−199,202**	**−267,742**

[1] These figures include the increase in outlays attributed to the earned income credit which results from reduction in tax rates. These outlays are: $4 million in fiscal year 1982, $31 million in 1983, $44 million in 1984, $41 million in 1985, and $38 million in 1986.
[2] Loss of less than $5 million.
[3] Negligible.
[4] Loss of less than $10 million.
[5] These figures include a reduction in receipts attributed to the leasing provisions of: $439 million in 1981, $2,649 million in 1982, $3,614 million in 1983, $5,065 million in 1984, $6,732 million in 1985, and $8,512 million in 1986.
[6] This estimate is based on limited information about reorganizations that were planned even without this provision. If such reorganizations would have increased markedly without this provision, the revenue loss could be substantial.
[7] Includes the $36 million reduction in tax liabilities for calendar year 1980.
[8] These estimates were made using the rate schedule enacted by the Act. This approach results in a lower revenue loss than one that would have been obtained if the prior law rates had been used.
[9] Gain of less than $5 million.
[10] Loss of less than $1 million.
[11] Revenue effects do not reflect transactions entered into after December 31, 1981. Total revenue effects of subsequent years might be affected by judicial decisions interpreting prior law.

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title I.—Individual income tax provisions:						
Sec. 101.—Rate cuts; rate reduction credit [1]	−3,642	−37,354	−75,820	−108,580	−127,868	−149,756
Sec. 102.—20-percent maximum rate on net capital gain for portion of 1981	−394					
Sec. 103.—Deduction for two-earner married couples		−3,541	−8,477	−10,189	−12,137	−14,332
Sec. 104.—Indexing					−21,022	−45,106
Secs. 111-115.—Partial exclusion for earned income from sources outside the U.S. and foreign housing costs, repeal of deduction for certain expenses of living abroad, and employees living in camps		−544	−544	−578	−651	−733
Sec. 121.—Deduction for charitable contributions for individuals who do not itemize deductions		−189	−188	−421	−2,344	−4,957
Sec. 122.—18-month period for rollover of principal residence increased to 2 years	[4]	[4]	[4]	[4]	[4]	[4]
Sec. 123.—One-time exclusion of gain increased to $125,000	−18	−53	−63	−76	−91	−110
Sec. 124.—Increases in child and dependent credit; exclusion of employer payments for dependent care assistance		−185	−232	−290	−349	−421

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 125.—Deduction for adoption expenses	−8	−9	−10	−11	−12	−13
Sec. 126.—Maximum rate of imputed interest for sale of land between related persons	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 127.—State legislators travel expenses	−8	−4	−6	−5	−8	−6
Sec. 128.—Rates of tax for principal campaign committees		(2)	(2)	(2)	(2)	(2)
Total, individual tax provisions	**−4,070**	**−41,879**	**−85,340**	**−120,150**	**−164,482**	**−215,434**
Title II.—Business incentive provisions:						
Secs. 201-209, 211.—Accelerated cost recovery system and related provisions [5]	−5,674	−12,043	−22,220	−30,938	−44,483	−62,172
Secs. 212 and 214.—Increase in investment tax credit for qualified rehabilitation expenditures; allow investment tax credit for certain rehabilitated buildings leased to tax-exempt organizations or to governmental units	−31	−204	−223	−265	−358	−491
Sec. 213.—Investment credit for used property—increase in dollar limit	−54	−69	−80	−90	−196	−201
Sec. 221.—Credit for increasing research activities	−154	−591	−847	−878	−817	−161

Footnotes are at end of table.

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 222.—Charitable contributions of scientific property used for research	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 223.—Suspension of regulations relating to allocation under section 861 of research and experimental expenditures		−114	−125	(2)		
Sec. 231.—Reduction in corporate tax rates		−231	−499	−542	−587	−633
Sec. 232.—Increase in accumulated earnings credit		−33	−36	−40	−44	−48
Secs. 233-234.—Subchapter S shareholders and treatment of trusts as subchapter S shareholders		(2)	(2)	(2)	(2)	(2)
Secs. 235-238.—Simplification of LIFO inventories and small business accounting		−181	−190	−194	−62	−68
Secs. 241-244.—Reorganizations involving financially troubled thrift institutions [6]	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 245.—Mutual savings banks with capital stock	−10	−10	−15	−20	−25	−25
Secs. 251-252.—Stock options and certain property transfers	(2)	(2)	(2)	(2)	15	23
Sec. 261.—Adjustments to new jobs tax credit	75	−167	32	92	143	182

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 262.—Section 189 made inapplicable to low-income housing		−36	−29	−24	−20	−22
Sec. 263.—Increase in deduction allowable to a corporation in any taxable year for charitable contributions		−88	−97	−106	−117	−129
Sec. 264.—Amortization of low-income housing	−3	−11	−20	−31	−41	−37
Sec. 265.—Deductibility of gifts by employers to employees	−4	−4	−5	−6	−8	−9
Sec. 266.—Deduction for motor carrier operating authority	−71	−71	−71	−71	−36	
Sec. 267.—Limitation on additions to bank loss reserves		−30				
Total, business incentive provisions	**−5,926**	**−13,883**	**−24,425**	**−33,113**	**−46,636**	**−63,791**
Title III.—Savings provisions: [7]						
Sec. 301.—Exclusion of interest on certain savings certificates	−20	−1,680	−1,631			
Sec. 302.—Repeal of $200 exclusion of interest; 15-percent net interest exclusion		2,472			−2,997	−3,342
Sec. 311.—Retirement savings		−1,167	−1,623	−2,025	−2,466	−2,776
Sec. 312.—Increase in amount of self-employed retirement plan deduction		−148	−171	−177	−194	−214

Footnotes are at end of table.

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 313.—Rollovers under bond purchase plans	(3)	(3)	(3)	(3)	(3)	(3)
Sec. 314.—Miscellaneous provisions	(3)	(3)	(3)	(3)	(3)	(3)
Sec. 321.—Reinvestment of dividends in the stock of public utilities		−346	−396	−451	−445	
Secs. 331-339.—Employee stock ownership plans and related provisions			−122	−1,138	−1,999	−2,632
Total, savings provisions	**−20**	**−869**	**−3,943**	**−3,791**	**−8,101**	**−8,964**
Title IV.—Estate and gift tax provisions:						
Sec. 401.—Increase in unified credit		−1,077	−1,981	−2,811	−3,834	−4,955
Sec. 402.—Reduction in maximum rates of tax		−172	−371	−556	−890	−1,067
Sec. 403.—Unlimited marital deduction		−303	−304	−311	−300	−289
Sec. 421.—Valuation of certain farm, etc., real property	−18	−280	−295	−326	−319	−305
Sec. 422.—Coordination of extensions of time for payment of estate tax where estate consists largely of a closely held business		−20	−16	−15	−12	−10
Sec. 423.—Treatment of certain contributions of works of art, etc		(2)	(2)	(2)	(2)	(2)

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 424.—Gifts made within 3 years of decedent's death not included in gross estate		−58	−50	−42	−38	−31
Sec. 425.—Basis of certain appreciated property transferred to decedent by gift within one year of death		[8]	[8]	[8]	[8]	[8]
Sec. 426.—Disclaimers		[2]	[2]	[2]	[2]	[2]
Sec. 427.—Repeal of deduction for bequests, etc., to certain minor children		[8]	[8]	[8]	[8]	[8]
Sec. 428.—Postponement of generation-skipping tax effective date		[3]	[3]	[3]	[3]	[3]
Sec. 429.—Credit against estate tax for transfer to Smithsonian	[3]					
Sec. 441.—Increase in annual gift tax exclusion; unlimited exclusion for certain transfers		−223	−214	−210	−196	−182
Sec. 442.—Time for payment of gift taxes						
Total, estate and gift tax provisions	**−18**	**−2,133**	**−3,231**	**−4,271**	**−5,589**	**−6,839**
Title V.—Tax straddles:						
Secs. 501-509.—Tax straddles and related provisions [9]	**1,421**	**722**	**112**	**60**	**36**	**16**

Footnotes are at end of table.

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title VI.—Energy provisions:						
Sec. 601.—$2,500 royalty credit for 1981; exemption for 1982 and thereafter	−514	−915	−959	−996	−1,252	−1,289
Sec. 602.—Reduction in tax imposed on newly discovered oil		−113	−316	−605	−973	−1,769
Sec. 603.—Exempt independent producer stripper well oil			−687	−732	−770	−804
Sec. 604.—Exemption from windfall profit tax of oil produced from interests held by or for the benefit of residential child care agencies	−15	−15	−15	−15	−15	−15
Sec. 611.—Application of credit for producing natural gas from a nonconventional source with the Natural Gas Policy Act of 1978						
Total, energy provisions	**−529**	**−1,043**	**−1,977**	**−2,348**	**−3,010**	**−3,877**
Title VII.—Administrative provisions:						
Sec. 701.—Prohibition of disclosure of methods for selection of tax returns for audits						
Sec. 711.—Changes in rate of interest for overpayments and underpayments		180	−95	200	−250	220

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Sec. 721.—Changes in penalties for false information with respect to withholding		(8)	(8)	(8)	(8)	(8)
Sec. 722.—Additions to tax in the case of valuation overstatements; increase in negligence penalty		(3)	(3)	(3)	(3)	(3)
Sec. 723.—Changes in requirements relating to information returns		(3)	(3)	(3)	(3)	(3)
Sec. 724.—Penalty for overstated deposit claims	(3)	(3)	(3)	(3)	(3)	(3)
Sec. 725.—Declaration of estimated tax not required in certain cases						
Sec. 731.—Cash management—corporate estimated payments						
Sec. 741.—Increases in railroad retirement employer and employee taxes	122	525	568	623	676	731
Sec. 742.—Advance transfer of railroad retirement amounts payable under social security financial interchange						
Sec. 743.—Amendments to section 3231 clarifying definition of compensation		(3)	(3)	(3)	(3)	(3)
Sec. 751.—Fees for filing tax court petitions		(3)	(3)	(3)	(3)	(3)
Total, administrative provisions	**122**	**705**	**473**	**823**	**426**	**951**

Footnotes are at end of table.

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Title VIII.—Miscellaneous provisions:						
Sec. 801.—Extension of moratorium on fringe benefits regulations						
Sec. 802.—3-year extension of exclusion for prepaid legal services		−23	−24	−27		
Sec. 811.—Tax-exempt financing for vehicles used for mass commuting		−1	−17	−48	−64	−64
Sec. 812.—Tax-exempt treatment of obligations of certain volunteer fire departments	(10)	(10)	(10)	(10)	(10)	(10)
Sec. 821.—2-year extension of telephone excise tax at 1 percent			708	802		
Sec. 822.—Exclusion of certain services from Federal Unemployment Tax Act	(10)					
Sec. 823.—Private foundation distributions		(2)	(2)	(2)	(2)	(2)
Sec. 831.—Technical amendments relating to dispositions of investment in U.S. real property	(3)	(3)	(3)	(3)	(3)	(3)
Sec. 832.—Modification of foreign investment company provisions	(2)	(2)	(2)	(2)	(2)	(2)
Total, miscellaneous provisions		**−24**	**667**	**727**	**−64**	**−64**

Table V-4.—Estimated Revenue Effects of the Provisions of the Economic Recovery Act of 1981 (H.R. 4242), Calendar Years 1981-1986—Continued

[In millions of dollars]

Provision	1981	1982	1983	1984	1985	1986
Grand Total, All Provisions	**−9,020**	**−58,404**	**−117,664**	**−162,063**	**−227,420**	**−298,002**

[1] These figures include the increase in outlays attributable to the earned income credit which results from reduction in tax rates. These outlays are: $3 million in calendar year 1981, $31 million in 1982, $44 million in 1983, $41 million in 1984, $38 million in 1985, and $35 million in calendar year 1986.

[2] Loss of less than $5 million.

[3] Negligible.

[4] Loss of less than $10 million.

[5] These figures include a reduction in liabilities attributed to the leasing provisions of: $1,859 million in 1981, $3,073 million in 1982, $4,425 million in 1983, $6,024 million in 1984, $7,792 million in 1985, and $9,591 million in 1986.

[6] This estimate is based on limited information about reorganizations that were planned even without this provision. If such reorganizations would have increased markedly without this provision, the revenue loss could be substantial.

[7] These estimates were made using the rate schedule enacted by the Act. This approach results in a lower revenue loss than one that would have been obtained if the prior law rates had been used.

[8] Gain of less than $5 million.

[9] Revenue effects do not reflect transactions entered into after December 31, 1981. Total revenue effects of subsequent years might be affected by judicial decisions interpreting prior law.

[10] Loss of less than $1 million.

APPENDIX:

NEW INDIVIDUAL INCOME TAX RATE SCHEDULES UNDER THE ACT FOR 1982, 1983, AND 1984 AND THEREAFTER

INDIVIDUAL RATE CUTS (SEC. 101 OF THE ACT)

(a) **Rate Reduction.**—Section 1 (relating to tax imposed) is amended to read as follows:[1]

SECTION 1. TAX IMPOSED.

(A) **Married Individuals Filing Joint Returns and Surviving Spouses.**—There is hereby imposed on the taxable income of every married individual (as defined in section 143) who makes a single return jointly with his spouse under section 6013, and every surviving spouse (as defined in section 2(a)), a tax determined in accordance with the following tables:

(1) For taxable years beginning in 1982.—

If taxable income is:	The tax is:
Not over $3,400	No tax.
Over $3,400 but not over $5,500	12% of the excess over $3,400.
Over $5,500 but not over $7,600	$252, plus 14% of the excess over $5,500.
Over $7,600 but not over $11,900	$546, plus 16% of the excess over $7,600.
Over $11,900 but not over $16,000	$1,234, plus 19% of the excess over $11,900.
Over $16,000 but not over $20,200	$2,013, plus 22% of the excess over $16,000.
Over $20,200 but not over $24,600	$2,937, plus 25% of the excess over $20,200.
Over $24,600 but not over $29,900	$4,037, plus 29% of the excess over $24,600.
Over $29,900 but not over $35,200	$5,574, plus 33% of the excess over $29,900.
Over $35,200 but not over $45,800	$7,323, plus 39% of the excess over $35,200.
Over $45,800 but not over $60,000	$11,457, plus 44% of the excess over $45,800.
Over $60,000 but not over $85,600	$17,705 plus 49% of the excess over $60,000.
Over $85,600	$30,249, plus 50% of the excess over $85,600.

(2) For taxable years beginning in 1983.—

If taxable income is:	The tax is:
Not over $3,400	No tax.
Over $3,400 but not over $5,500	11% of the excess over $3,400.
Over $5,500 but not over $7,600	$231, plus 13% of the excess over $5,500.
Over $7,600 but not over $11,900	$504, plus 15% of the excess over $7,600.
Over $11,900 but not over $16,000	$1,149, plus 17% of the excess over $11,900.
Over $16,000 but not over $20,200	$1,846, plus 19% of the excess over $16,000.
Over $20,200 but not over $24,600	$2,644, plus 23% of the excess over $20,200.
Over $24,600 but not over $29,900	$3,656, plus 26% of the excess over $24,600.
Over $29,900 but not over $35,200	$5,034, plus 30% of the excess over $29,900.
Over $35,200 but not over $45,800	$6,624, plus 35% of the excess over $35,200.
Over $45,800 but not over $60,000	$10,334, plus 40% of the excess over $45,800.
Over $60,000 but not over $85,600	$16,014, plus 44% of the excess over $60,000.
Over $85,600 but not over $109,400	$27,278, plus 48% of the excess over $85,600.
Over $109,400	$38,702, plus 50% of the excess over $109,400.

(3) For taxable years beginning after 1983.—

If taxable income is:	The tax is:
Not over $3,400	No tax.
Over $3,400 but not over $5,500	11% of the excess over $3,400.
Over $5,500 but not over $7,600	$231, plus 12% of the excess over $5,500.
Over $7,600 but not over $11,900	$483, plus 14% of the excess over $7,600.
Over $11,900 but not over $16,000	$1,085, plus 16% of the excess over $11,900.
Over $16,000 but not over $20,200	$1,741 plus 18% of the excess over $16,000.
Over $20,200 but not over $24,600	$2,497 plus 22% of the excess over $20,200.
Over $24,600 but not over $29,900	$3,465 plus 25% of the excess over $24,600.
Over $29,900 but not over $35,200	$4,790 plus 28% of the excess over $29,900.
Over $35,200 but not over $45,800	$6,274 plus 33% of the excess over $35,200.
Over $45,800 but not over $60,000	$9,772 plus 38% of the excess over $45,800.
Over $60,000 but not over $85,600	$15,168 plus 42% of the excess over $60,000.
Over $85,600 but not over $109,400	$25,920 plus 45% of the excess over $85,600.
Over $109,400 but not over $162,400	$36,630 plus 49% of the excess over $109,400.
Over $162,400	$62,600 plus 50% of the excess over $162,400.

(b) Heads of Households.—There is hereby imposed on the taxable income of every individual who is the head of a household (as defined in section 2(b)) a tax determined in accordance with the following tables:

(1) For taxable years beginning in 1982.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $4,400	12% of the excess over $2,300.
Over $4,400 but not over $6,500	$252, plus 14% of the excess over $4,400.
Over $6,500 but not over $8,700	$546, plus 16% of the excess over $6,500.
Over $8,700 but not over $11,800	$898, plus 20% of the excess over $8,700.
Over $11,800 but not over $15,000	$1,518 plus 22% of the excess over $11,800.
Over $15,000 but not over $18,200	$2,222 plus 23% of the excess over $15,000.
Over $18,200 but not over $23,500	$2,958 plus 28% of the excess over $18,200.
Over $23,500 but not over $28,800	$4,442 plus 32% of the excess over $23,500.
Over $28,800 but not over $34,100	$6,138 plus 38% of the excess over $28,800.
Over $34,100 but not over $44,700	$8,152 plus 41% of the excess over $34,100.
Over $44,700 but not over $60,600	$12,498 plus 49% of the excess over $44,700.
Over $60,600	$20,289 plus 50% of the excess over $60,600.

[1] For tax years beginning in 1981, there is a tax credit against regular tax equal to 1¼ percent of regular tax liability before other credits. This credit corresponds to a 5-percent reduction in withholding, effective on October 1, 1981.

(2) For taxable years beginning in 1983.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $4,400	11% of the excess over $2,300.
Over $4,400 but not over $6,500	$231, plus 13% of the excess over $4,400.
Over $6,500 but not over $8,700	$504, plus 15% of the excess over $6,500.
Over $8,700 but not over $11,800	$834, plus 18% of the excess over $8,700.
Over $11,800 but not over $15,000	$1,392, plus 19% of the excess over $11,800.
Over $15,000 but not over $18,200	$2,000, plus 21% of the excess over $15,000.
Over $18,200 but not over $23,500	$2,672, plus 25% of the excess over $18,200.
Over $23,500 but not over $28,800	$3,997, plus 29% of the excess over $23,500.
Over $28,800 but not over $34,100	$5,534, plus 34% of the excess over $28,800.
Over $34,100 but not over $44,700	$7,336, plus 37% of the excess over $34,100.
Over $44,700 but not over $60,600	$11,258, plus 44% of the excess over $44,700.
Over $60,600 but not over $81,800	$18,254, plus 48% of the excess over $60,600.
Over $81,800	$28,430, plus 50% of the excess over $81,800.

(3) For taxable years beginning after 1983.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $4,400	11% of the excess over $2,300.
Over $4,400 but not over $6,500	$231, plus 12% of the excess over $4,400.
Over $6,500 but not over $8,700	$483, plus 14% of the excess over $6,500.
Over $8,700 but not over $11,800	$791, plus 17% of the excess over $8,700.
Over $11,800 but not over $15,000	$1,318, plus 18% of the excess over $11,800.
Over $15,000 but not over $18,200	$1,894, plus 20% of the excess over $15,000.
Over $18,200 but not over $23,500	$2,534, plus 24% of the excess over $18,200.
Over $23,500 but not over $28,800	$3,806, plus 28% of the excess over $23,500.
Over $28,800 but not over $34,100	$5,290, plus 32% of the excess over $28,800.
Over $34,100 but not over $44,700	$6,986, plus 35% of the excess over $34,100.
Over $44,700 but not over $60,600	$10,696, plus 42% of the excess over $44,700.
Over $60,600 but not over $81,800	$17,374, plus 45% of the excess over $60,600.
Over $81,800 but not over $108,300	$26,914, plus 48% of the excess over $81,800.
Over $108,300	$39,634, plus 50% of the excess over $108,300.

(c) Unmarried Individuals (Other Than Surviving Spouses and Heads of Households).—There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 143) a tax determined in accordance with the following tables:

(1) For taxable years beginning in 1982.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $3,400	12% of the excess over $2,300.
Over $3,400 but not over $4,400	$132, plus 14% of the excess over $3,400.
Over $4,400 but not over $6,500	$272, plus 16% of the excess over $4,400.
Over $6,500 but not over $8,500	$608, plus 17% of the excess over $6,500.
Over $8,500 but not over $10,800	$948, plus 19% of the excess over $8,500.
Over $10,800 but not over $12,900	$1,385, plus 22% of the excess over $10,800.
Over $12,900 but not over $15,000	$1,847, plus 23% of the excess over $12,900.
Over $15,000 but not over $18,200	$2,330, plus 27% of the excess over $15,000.
Over $18,200 but not over $23,500	$3,194, plus 31% of the excess over $18,200.
Over $23,500 but not over $28,800	$4,837, plus 35% of the excess over $23,500.
Over $28,800 but not over $34,100	$6,692, plus 40% of the excess over $28,800.
Over $34,100 but not over $41,500	$8,812, plus 44% of the excess over $34,100.
Over $41,500	$12,068, plus 50% of the excess over $41,500.

(2) For taxable years beginning in 1983.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $3,400	11% of the excess over $2,300.
Over $3,400 but not over $4,400	$121, plus 13% of the excess over $3,400.
Over $4,400 but not over $8,500	$251, plus 15% of the excess over $4,400.
Over $8,500 but not over $10,800	$866, plus 17% of the excess over $8,500.
Over $10,800 but not over $12,900	$1,257, plus 19% of the excess over $10,800.
Over $12,900 but not over $15,000	$1,656, plus 21% of the excess over $12,900.
Over $15,000 but not over $18,200	$2,097, plus 24% of the excess over $15,000.
Over $18,200 but not over $23,500	$2,865, plus 28% of the excess over $18,200.
Over $23,500 but not over $28,800	$4,349, plus 32% of the excess over $23,500.
Over $28,800 but not over $34,100	$6,045, plus 36% of the excess over $28,800.
Over $34,100 but not over $41,500	$7,953, plus 40% of the excess over $34,100.
Over $41,500 but not over $55,300	$10,913, plus 45% of the excess over $41,500.
Over $55,300	$17,123, plus 50% of the excess over $55,300.

(3) For taxable years beginning after 1983.—

If taxable income is:	The tax is:
Not over $2,300	No tax.
Over $2,300 but not over $3,400	11% of the excess over $2,300.
Over $3,400 but not over $4,400	$121, plus 12% of the excess over $3,400.
Over $4,400 but not over $6,500	$241, plus 14% of the excess over $4,400.
Over $6,500 but not over $8,500	$535, plus 15% of the excess over $6,500.
Over $8,500 but not over $10,800	$835, plus 16% of the excess over $8,500.
Over $10,800 but not over $12,900	$1,203, plus 18% of the excess over $10,800.

If taxable income is:	The tax is:
Over $12,900 but not over $15,000	$1,581, plus 20% of the excess over $12,900.
Over $15,000 but not over $18,200	$2,001, plus 23% of the excess over $15,000.
Over $18,200 but not over $23,500	$2,737, plus 26% of the excess over $18,200.
Over $23,500 but not over $28,800	$4,115, plus 30% of the excess over $23,500.
Over $28,800 but not over $34,100	$5,705, plus 34% of the excess over $28,800.
Over $34,100 but not over $41,500	$7,507, plus 38% of the excess over $34,100.
Over $41,500 but not over $55,300	$10,319, plus 42% of the excess over $41,500.
Over $55,300 but not over $81,800	$16,115, plus 48% of the excess over $55,300.
Over $81,800	$28,835, plus 50% of the excess over $81,800.

(d) Married Individuals Filing Separate Returns.—There is hereby imposed on the taxable income of every married individual (as defined in section 143) who does not make a single return jointly with his spouse under section 6013 a tax determined in accordance with the following tables:

(1) For taxable years beginning in 1982.—

If taxable income is:	The tax is:
Not over $1,700	No tax.
Over $1,700 but not over $2,750	12% of the excess over $1,700.
Over $2,750 but not over $3,800	$126, plus 14% of the excess over $2,750.
Over $3,800 but not over $5,950	$273, plus 16% of the excess over $3,800.
Over $5,950 but not over $8,000	$617, plus 19% of the excess over $5,950.
Over $8,000 but not over $10,100	$1,006, plus 22% of the excess over $8,000.
Over $10,100 but not over $12,300	$1,468, plus 25% of the excess over $10,100.
Over $12,300 but not over $14,950	$2,018, plus 29% of the excess over $12,300.
Over $14,950 but not over $17,600	$2,787, plus 33% of the excess over $14,950.
Over $17,600 but not over $22,900	$3,661, plus 39% of the excess over $17,600.
Over $22,900 but not over $30,000	$5,728, plus 44% of the excess over $22,900.
Over $30,000 but not over $42,800	$8,852, plus 49% of the excess over $30,000.
Over $42,800	$15,124, plus 50% of the excess over $42,800.

(2) For taxable years beginning in 1983.—

If taxable income is:	The tax is:
Not over $1,700	No tax.
Over $1,700 but not over $2,750	11% of the excess over $1,700.
Over $2,750 but not over $3,800	$115, plus 13% of the excess over $2,750.
Over $3,800 but not over $5,950	$252, plus 15% of the excess over $3,800.
Over $5,950 but not over $8,000	$574, plus 17% of the excess over $5,950.
Over $8,000 but not over $10,100	$923, plus 19% of the excess over $8,000.
Over $10,100 but not over $12,300	$1,322, plus 23% of the excess over $10,100.
Over $12,300 but not over $14,950	$1,828, plus 26% of the excess over $12,300.
Over $14,950 but not over $17,600	$2,517, plus 30% of the excess over $14,950.

If taxable income is:	The tax is:
Over $17,600 but not over $22,900	$3,312, plus 35% of the excess over $17,600.
Over $22,900 but not over $30,000	$5,167, plus 40% of the excess over $22,900.
Over $30,000 but not over $42,800	$8,007, plus 44% of the excess over $30,000.
Over $42,800 but not over $54,700	$13,639, plus 48% of the excess over $42,800.
Over $54,700	$19,351, plus 50% of the excess over $54,700.

(3) For taxable years beginning after 1983.—

If taxable income is:	The tax is:
Not over $1,700	No tax.
Over $1,700 but not over $2,750	11% of the excess over $1,700.
Over $2,750 but not over $3,800	$115, plus 12% of the excess over $2,750.
Over $3,800 but not over $5,950	$241, plus 14% of the excess over $3,800.
Over $5,950 but not over $8,000	$542, plus 16% of the excess over $5,950.
Over $8,000 but not over $10,100	$870, plus 18% of the excess over $8,000.
Over $10,100 but not over $12,300	$1,248, plus 22% of the excess over $10,100.
Over $12,300 but not over $14,950	$1,732, plus 25% of the excess over $12,300.
Over $14,950 but not over $17,600	$2,395, plus 28% of the excess over $14,950.
Over $17,600 but not over $22,900	$3,137, plus 33% of the excess over $17,600.
Over $22,900 but not over $30,000	$4,886, plus 38% of the excess over $22,900.
Over $30,000 but not over $42,800	$7,584, plus 42% of the excess over $30,000.
Over $42,800 but not over $54,700	$12,960, plus 45% of the excess over $42,800.
Over $54,700 but not over $81,200	$18,315, plus 49% of the excess over $54,700.
Over $81,200	$31,300, plus 50% of the excess over $81,200.

(e) Estates and Trusts.—There is hereby imposed on the taxable income of every estate and trust taxable under this subsection a tax determined in accordance with the following tables:

(1) For taxable years beginning in 1982.—

If taxable income is:	The tax is:
Not over $1,050	12% of taxable income.
Over $1,050 but not over $2,100	$126, plus 14% of the excess over $1,050.
Over $2,100 but not over $4,250	$273, plus 16% of the excess over $2,100.
Over $4,250 but not over $6,300	$617, plus 19% of the excess over $4,250.
Over $6,300 but not over $8,400	$1,006, plus 22% of the excess over $6,300.
Over $8,400 but not over $10,600	$1,468, plus 25% of the excess over $8,400.
Over $10,600 but not over $13,250	$2,018, plus 29% of the excess over $10,600.
Over $13,250 but not over $15,900	$2,787, plus 33% of the excess over $13,250.
Over $15,900 but not over $21,200	$3,661, plus 39% of the excess over $15,900.
Over $21,200 but not over $28,300	$5,728, plus 44% of the excess over $21,200.
Over $28,300 but not over $41,100	$8,852, plus 49% of the excess over $28,300.
Over $41,100	$15,124, plus 50% of the excess over $41,100.

(2) For taxable years beginning in 1983.—

If taxable income is:	The tax is:
Not over $1,050	11% of taxable income.
Over $1,050 but not over $2,100	$115, plus 13% of the excess over $1,050.
Over $2,100 but not over $4,250	$252, plus 15% of the excess over $2,100.
Over $4,250 but not over $6,300	$574, plus 17% of the excess over $4,250.
Over $6,300 but not over $8,400	$923, plus 19% of the excess over $6,300.
Over $8,400 but not over $10,600	$1,322, plus 23% of the excess over $8,400.
Over $10,600 but not over $13,250	$1,828, plus 26% of the excess over $10,600.
Over $13,250 but not over $15,900	$2,517, plus 30% of the excess over $13,250.
Over $15,900 but not over $21,200	$3,312, plus 35% of the excess over $15,900.
Over $21,200 but not over $28,300	$5,167 plus 40% of the excess over $21,200.
Over $28,300 but not over $41,100	$8,007, plus 44% of the excess over $28,300.
Over $41,100 but not over $53,000	$13,639, plus 48% of the excess over $41,100.
Over $53,000	$19,351, plus 50% of the excess over $53,000.

(3) For taxable years beginning after 1983.—

If taxable income is:	The tax is:
Not over $1,050	11% of taxable income.
Over $1,050 but not over $2,100	$115, plus 12% of the excess over $1,050.
Over $2,100 but not over $4,250	$241, plus 14% of the excess over $2,100.
Over $4,250 but not over $6,300	$542, plus 16% of the excess over $4,250.
Over $6,300 but not over $8,400	$870, plus 18% of the excess over $6,300.
Over $8,400 but not over $10,600	$1,248 plus 22% of the excess over $8,400.
Over $10,600 but not over $13,250	$1,732, plus 25% of the excess over $10,600.
Over $13,250 but not over $15,900	$2,395, plus 28% of the excess over $13,250.
Over $15,900 but not over $21,200	$3,137 plus 33% of the excess over $15,900.
Over $21,200 but not over $28,300	$4,886, plus 38% of the excess over $21,200.
Over $28,300 but not over $41,100	$7,584, plus 42% of the excess over $28,300.
Over $41,100 but not over $53,000	$12,960, plus 45% of the excess over $41,100.
Over $53,000 but not over $79,500	$18,315, plus 49% of the excess over $53,000.
Over $79,500	$31,300, plus 50% of the excess over $79,500.

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