

GENERAL EXPLANATION
OF THE
TAX REFORM ACT OF 1969
H.R. 13270, 91ST CONGRESS, PUBLIC LAW 91-172

PREPARED BY THE
STAFF OF THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION



DECEMBER 3, 1970



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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., December 3, 1970.

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

DEAR MESSRS. CHAIRMEN: While committee reports explain the position of the House Committee on Ways and Means, or the position of the Senate Committee on Finance, they do not in all cases explain the legislation as finally passed by the Congress. This becomes particularly important in the case of major legislation where there are many changes between the bill as passed by the House, or as passed by the Senate, and that which finally becomes public law. The Tax Reform Act of 1969, because of its comprehensive scope and because of the many changes which were made in this legislation, both by the Senate and subsequently by the conferees, is an illustration of where the differences were especially significant.

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

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

This material has basically been prepared by the staff of the Joint Committee on Internal Revenue Taxation, but we wish to thank the Tax Legislative Counsel's office of the Treasury Department for reviewing the material prior to its publication and giving us its comments on the various sections. The Joint Committee staff, of course, assumes full responsibility for the contents of this document. It is hoped that this document will be useful as source material on the Tax Reform Act of 1969.

Sincerely yours,

LAURENCE N. WOODWORTH,
Chief of Staff.

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I. SUMMARY

The Tax Reform Act of 1969 (H.R. 13270) is a substantive and comprehensive reform of the income tax laws. As the House and Senate Committee Reports suggest, there was no prior tax reform bill of equal substantive scope.

The congressional consideration of this Act lasted eleven months and one day. The schedule of the various actions by the committees on the bill was as follows:

January 29, 1969: Announcement by the House Committee on Ways and Means of its hearings on tax reform.

February 18, 1969 to April 24, 1969: Hearings before the House Committee on Ways and Means on tax reform.

April 29, 1969 to August 2, 1969: Markup of the bill by the House Committee on Ways and Means.

August 5, 1969: Bill reported by the House Committee on Ways and Means.

August 6, 1969: Obtained a closed rule on the bill from the House Committee on Rules.

August 6 and 7, 1969: Bill considered by the House and passed by a vote of 394 to 30.

September 4, 1969 to October 8, 1969: Hearings before the Senate Committee on Finance on tax reform.

October 9, 1969 to October 31, 1969: Markup of the bill by the Senate Committee on Finance.

November 21, 1969: Bill reported by the Senate Committee on Finance.

November 24, 1969 to December 11, 1969: Bill considered by the Senate and passed by a vote of 69 to 22.

December 15, 1969 to December 19, 1969: Meeting of the conference committee of the House and Senate on the Tax Reform Bill of 1969.

December 22, 1969: Approval of the Conference Report by both the House and Senate by votes of 381 to 2 and 71 to 6, respectively.

December 30, 1969: Tax Reform Act of 1969 (Public Law 91-172) signed by the President.

From time to time, since the enactment of the present income tax over 50 years ago, various tax incentives or preferences have been added to the internal revenue laws. Increasingly in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the code primarily to aid limited segments of the economy. In fact, in many cases these taxpayers have found ways to pile one advantage on top of another. The House and Senate agreed that this was an intolerable situation. It should not have been possible for 154 individuals with adjusted gross incomes of \$200,000 or more to pay no Federal income tax on 1966 income. Ours is primarily a self-assessment system. If taxpayers are

generally to pay their taxes on a voluntary basis, they must feel that these taxes are fair. Moreover, only by sharing the tax burden on an equitable basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers. It is for these reasons that the amendments in this Act contain some 41 categories of tax reform provisions described in summary fashion at the end of this section.

Despite the comprehensive scope of the Tax Reform Act of 1969, the committees recognized that much remains to be done. In some cases, income tax problems had to be postponed for further analysis and study. Moreover, the entire area of estate and gift tax reform lies outside the scope of this Act and remains an area for future consideration.

Tax relief changes.—In the area of individual income tax relief, this Act very substantially improves the tax structure. When the relief measures are fully implemented in 1973, they will represent a reduction of over \$9 billion in individual income tax liability. This relief, combined with the individual income tax reform measures, provides substantial tax reductions in the lowest income classes, with decreasing reductions for those with higher incomes, until finally, for the income classes of \$100,000 or over, significant tax increases result from the reform measures in this Act.

On an overall basis, this Act provides an average reduction in tax liability of 10.6 percent; however, for returns with adjusted gross incomes of \$3,000 or less, the average reduction is almost 70 percent and for those with incomes between \$3,000 and \$5,000 the average reduction is over 33 percent. The changes in tax liability provided by the reform and relief provisions in this Act are shown in table 2 of this general explanation which can be summarized as follows:

Percentage tax increase or decrease under the reform and relief provisions of the Tax Reform Act of 1969

Adjusted gross income class (thousands)	Percentage increase (+) or decrease (-)
\$0 to \$3.....	-69.8
\$3 to \$5.....	-33.2
\$5 to \$7.....	-19.9
\$7 to \$10.....	-15.8
\$10 to \$15.....	-12.6
\$15 to \$20.....	-8.6
\$20 to \$50.....	-5.1
\$50 to \$100.....	-1.9
\$100 and over.....	+7.2
Total	-10.6

The tax reduction in this act was carefully tailored to deal with what the Congress considered to be important national objectives:

(1) Removal of all income tax from the poor and substantial reductions of the income tax for the near poor through an enlarged minimum standard deduction and increased exemption allowances.

(2) Obtaining substantial simplification of the tax structure for the great bulk of taxpayers by encouraging 11 million returns to shift from returns with itemized deductions to returns with larger standard deductions. This will increase from 58 percent to

about 73 percent the portion of all returns using the simple standard deduction.

(3) Special tax reductions for single persons to insure that their tax burden in no event is more than 20 percent above that of married couples with comparable taxable income. At the present time (until 1971 when the new rates are effective), in some cases they are paying 42 percent more than married couples with the same taxable income.

Fiscal policy and revenue implications.—The amount of the individual income tax relief provided in the Act—\$9 billion when fully effective in 1973—has been carefully designed from the standpoint of its fiscal implications. (See table 1.)

These implications were considered particularly important in view of the inflationary pressures then persisting. The tax reform and tax relief provisions in this Act (including repeal of the investment credit), even without the effect of the extension of the surcharge and excise taxes, are expected to increase revenues by approximately \$2.2 billion in calendar year 1970 and result in a net tax reduction of only \$500 million in calendar year 1971. In fact, if the effect of continuing the surcharge at a 5 percent rate for the first six months of 1970 and the excise tax extensions on automobiles and communications services are also taken into account, the revenue effect of the Act is to raise \$6.5 billion in 1970 and almost \$300 million in 1971. It was considered important to maintain this fiscal balance in order not to refuel the inflationary fires. In terms of fiscal year effect, the provisions of this act are estimated to increase receipts by \$3.7 billion in fiscal year 1970 and \$2.7 billion in fiscal year 1971 (including the surcharge and excise tax changes).

In the long run, the revenue raised by the reform measures included in the Act is expected to amount to about \$3.3 billion, before taking into account the repeal of the investment credit. After the repeal of the credit is taken into account, the revenue raised by the Act amounts to \$6.6 billion.

All of the revenue figures shown in this document are based on 1969 levels of income. No attempt is made to take into account probable growth in general receipts or possible further revenue increases from the reform provisions of the Act as the economy grows or, on the other hand, possible further increases in the effect of the tax reduction provisions of the Act because of the same factors.

TAX REFORM MEASURES

1. *Private foundations.*—The Act makes substantial changes in the treatment of private foundations (certain sec. 501(c)(3) organizations—including religious, charitable, educational organizations—which are not broadly, publicly supported). The permissible activities of private foundations are tightened to require current distribution of income for charitable and similar purposes, to prevent self-dealing between the foundation and certain related (“disqualified”) persons, to limit foundations’ holdings of unrelated businesses, to prevent putting foundations’ assets in jeopardy by financial speculation, and to give assurance that foundations’ activities are properly restricted as provided by the exemption provisions of the tax laws. In addition,

each foundation must pay an annual excise tax of 4 percent of its net investment income and must give extensive publicity to its activities.

An organization (whether or not a private foundation) organized after October 9, 1969, which fails to notify the Internal Revenue Service of its claim to be exempt under section 501(c)(3) is not exempt under this section even though organized and operated exclusively for the exempt purposes listed in the section.

Substantially all exempt organizations are required to file information returns with essentially the same data previously required only of private foundations. Substantially all of this information is to be available to the public.

2. *Tax-exempt organizations generally.*—The Act restricts unrelated activities of tax-exempt organizations. First, an exempt organization acquiring debt-financed property (which, in effect, allows a sharing of its exemption with private businesses) is subject to taxation in the proportion in which the property is financed by the debt. Second, the unrelated business income tax is extended to virtually all tax-exempt organizations not previously covered, including churches (after 1975). Third, the unrelated business income tax is extended to the investment income of certain tax-exempt organizations set up primarily for the benefit of their members, such as social clubs and employees' beneficiary associations. Fourth, where a tax-exempt organization owns more than 80 percent of a taxable subsidiary, the interest, annuities, royalties and rents received by it are to be treated as "unrelated business income" and are subject to tax. Fifth, in the case of a taxable membership organization, the deduction for expenses incurred in supplying services, facilities or goods to members is generally to be allowed (after 1970) only to the extent of the income received from these members. Finally, the Act provides that the term "trade or business" for purposes of the unrelated business income tax includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

3. *Charitable contributions.*—The general charitable contribution deduction limit is increased to 50 percent (except for gifts of appreciated property) and the unlimited charitable deduction is phased out over a five year period. The extra tax benefits derived from charitable contributions of appreciated property are restricted in the case of gifts to certain private foundations, gifts of ordinary income property, gifts of certain tangible personal property (where unrelated to the charitable organization's exempt purpose) and so-called bargain sales. Finally, the two-year charitable trust rule is repealed and a number of changes are made to limit charitable deductions for gifts and the use of property, and in the case of charitable remainder and charitable income trusts.

4. *Farm losses.*—Taxpayers who deduct farm losses against their nonfarm income generally must treat capital gains arising on the subsequent sale of farm assets as ordinary income. For individuals, this recapture rule applies only to losses over \$25,000 and only if nonfarm income is over \$50,000. The Act also provides for the recapture of depreciation on the sale of livestock and a more effective treatment of hobby losses. The holding period for cattle and horses is extended, provision is made for the recapture of soil and water conservation or land clearing expenditures on the sale of farm land, and the costs of planting citrus groves are required to be capitalized.

5. *Interest deduction.*—A deduction is denied (with a two-year delay in effective date) for 50 percent of interest incurred by a taxpayer on funds borrowed to carry investments to the extent the interest exceeds the taxpayer's net investment income, his long-term capital gains and \$25,000. The disallowed interest, however, may be carried over to subsequent years.

6. *Moving expenses.*—The Act broadens the definition of moving expenses for deduction purposes, provides that reimbursed taxpayers are to be treated in the same manner for such expenses as unreimbursed taxpayers, extends the moving expense deduction to self-employed persons, and increases the minimum 20-mile test to 50 miles.

7. *Minimum tax.*—This tax, which applies to both individuals and corporations, supplements the action of the specific remedial provisions of the Act in curtailing tax preferences. It is computed by (1) totaling the amount of tax preferences received by the taxpayer (from the broad category of tax preferences specified in the Act), (2) subtracting from this total a \$30,000 exemption and the amount of the taxpayer's regular Federal income tax for the year, and (3) applying a 10-percent tax rate to the remainder.

8. *Income averaging.*—Income averaging is simplified and made more generally available by extending it to capital gains and certain other income, and permitting it to be used by taxpayers whose incomes increase 20 percent above the base period as compared with 33 percent under prior law.

9. *Restricted property.*—In the case of so-called restricted stock and other restricted property, the interest in the property is taxed at the time of receipt unless there is a substantial risk of forfeiture. In the latter event, the property is taxed when the possibility of forfeiture is removed at its full value at that time, unless the recipient elects to be taxed in the year of receipt.

10. *Accumulation trusts, multiple trusts, etc.*—Beneficiaries of accumulation trusts, including multiple trusts, are taxed on distributions of accumulated income from trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. In the case of capital gains, an unlimited throwback rule is provided (generally after 1971) for those gains allocated to the corpus of a trust which has accumulated its income.

11. *Multiple corporations.*—Multiple surtax exemptions in the case of related corporations are withdrawn over a 6-year period. As a result, for taxable years beginning after December 31, 1974, a controlled group of corporations is limited to one \$25,000 surtax exemption.

12. *Corporate mergers.*—The Act provides tests to determine when "debt" is in fact "equity" so as to make the interest deduction unavailable where this "debt" is used in acquiring other companies. In addition, the use of the installment method of reporting gains is restricted where readily marketable debt is received. Limiting changes also are made in the treatment of original issue discount and other situations. In addition, the Treasury Department is provided with authority to issue guidelines distinguishing between debt and equity for tax purposes.

13. *Stock dividends.*—The Act provides for the taxation of stock dividends where one group of shareholders receive a distribution in

cash while the proportionate interests of other shareholders are increased.

14. *Commercial banks.*—The special tax advantage that commercial banks derived under prior law because they were permitted tax deductions for building up bad debt reserves to 2.4 percent of outstanding uninsured loans is eliminated gradually over a period of 18 years. By 1988, banks will be required to base their tax deductions for additions for bad debt reserves on their actual experience. To provide for the possibility of substantial future losses, net operating losses incurred by commercial banks and other financial institutions in taxable years beginning after December 31, 1975, will be carried back 10 years instead of 3 years as under prior law. (This is in addition to the 5-year carryforward). Also, capital gains treatment is withdrawn for bonds held by banks and other financial institutions in the course of their business.

15. *Mutual savings banks and savings and loan associations.*—The Act substantially reduces the special bad debt reserve deductions available to mutual savings banks and savings and loan associations. The 3-percent method is eliminated and the prior law 60-percent method is to be reduced to 40 percent over a 10-year period. In addition the intercorporate dividends deduction is allocated between the portion of income subject to tax and the portion allowed as a bad debt reserve deduction.

16. *Mergers of savings and loan associations.*—In those cases where there is a tax-free reorganization or liquidation and section 381 applies (relating to carryovers in certain corporate acquisitions), the bad debt reserves do not have to be restored to income.

17. *Depreciation allowed regulated industries.*—Depreciation in the case of certain regulated industries is limited for new property to straight line depreciation, unless the appropriate regulatory agency permits the company to take accelerated depreciation, and “normalize” its current tax reduction. For pre-1970 property, no faster method of depreciation may be used than was used in mid-1969. Generally, companies already on “flow-through” cannot change without permission of the regulatory agency, except for a provision permitting a company to elect in the first half of 1970 to shift to the straight-line-or-normalization rule as to new expansion property.

18. *Earnings and profits adjustment for depreciation.*—Corporations must compute earnings and profits on the basis of straight line depreciation. This prevents the passing of the tax benefit of accelerated depreciation through to stockholders in the form of “tax-free dividends”. This rule does not apply to foreign corporations deriving little income from the United States.

19. *Natural resources.*—The percentage depletion rate for oil and gas wells is reduced from 27½ percent of gross income to 22 percent. The depletion rate also is cut to 22 percent for minerals eligible for a 23 percent rate under prior law and to 14 percent for most minerals eligible for a 15 percent rate under prior law.

Percentage depletion for oil shale is applied on the value after retorting. Percentage depletion is also allowed for minerals (other than sodium chloride) extracted from the Great Salt Lake and other saline perennial lakes in the United States.

Carved-out and other production payments (including ABC transactions) are treated as if the payments were loans by the owner of the

payment to the owner of the mineral property. This prevents the use of carve-outs to increase percentage depletion payments and foreign tax credits. It also eliminates the possibility of purchasing mineral property with money which is not treated as taxable income to the buyer. Finally, recapture rules are applied to mining exploration expenditures not subject to recapture under prior law and the foreign tax credit is disallowed to the extent foreign taxes are attributable to the deduction allowed against U.S. tax for percentage depletion.

20. *Alternative capital gains tax rate.*—The Act gradually eliminates the alternative tax on long-term capital gains for individual taxpayers to the extent they have capital gains of more than \$50,000. Long-term capital gains up to \$50,000 received by individuals continue to qualify for the 25-percent alternative capital gains tax rate. However, the maximum tax rate on that part of long-term capital gains above \$50,000 is increased to 29.5 percent in 1970, 32.5 percent in 1971, and 35 percent (one-half the 70 percent top tax rate applicable to ordinary income) in 1972 and later years. The alternative tax rate on corporate long-term capital gains income is increased to 28 percent in 1970 and 30 percent in 1971 and later years.

21. *Capital gains and losses.*—The Act requires net long-term capital losses (in excess of net short-term capital gains) of individuals to be reduced by 50 percent before they offset ordinary income. Where separate returns are filed, the deduction of capital losses against ordinary income is limited to \$500 for each spouse. Ordinary income tax treatment instead of capital gains treatment is provided for (1) employer contributions for plan years beginning after 1969 to pension and profit-sharing plans paid out as part of a lump-sum distribution, (2) gains from the sale of memorandums and letters by a person whose efforts created them (or for whom they were produced), (3) transfers of franchises, trademarks, and trade names where the transferor retains significant rights, powers, or continuing interests, and (4) contingent payments received under franchises, trademark, or trade name transfer agreements. In addition, corporations are granted a three-year loss carryback for net capital losses.

22. *Real estate depreciation.*—Real estate depreciation allowances are substantially curtailed. The 200-percent declining balance method and other fast forms of depreciation are restricted to new residential housing. Other new real estate is restricted to the 150-percent declining balance method. Used properties acquired in the future are limited to straight line depreciation, except for used residential housing which is eligible for allowances at 125 percent of the straight line method where the property still has a useful life of more than 20 years. In addition, stricter recapture rules are imposed, particularly for nonresidential property, to make sure that a larger proportion of gains on the sale of property (which result from accelerated depreciation allowances taken previously) are taxed as ordinary income.

23. *Subchapter S corporations.*—In the case of subchapter S corporations (that is, corporations treated somewhat like partnerships), the Act limits (after 1970) the tax deductions for amounts set aside under qualified pension plans for shareholder-employees (one who owns more than 5 percent of the corporation's stock) to 10 percent of the compensation paid or \$2,500, whichever is less.

24. *Arbitrage bonds.*—The Federal income tax exemption for interest payments on bonds issued by State and local governments is not to cover arbitrage bonds issued after October 9, 1969.

25. *Amounts received under insurance contracts for certain living expenses.*—An individual whose residence is damaged or destroyed by fire, storm or other casualty is not to be taxed on insurance reimbursements for the extra living expenses he and his family incur because of the loss of use of his residence.

26. *Deductibility of treble damages, fines, penalties.*—The Act codifies the judicial rule that deductions are not to be allowed for fines paid for the violation of any law and denies deductions for two-thirds of treble damage payments under the antitrust laws, for bribes of public officials, and for unlawful bribes or “kickbacks.”

27. *Deductibility of accrued vacation pay.*—Deductions for accrued vacation pay is not to be denied for any taxable year ending before January 1, 1971, solely because the liability to a specific person for vacation pay is not clearly estimated or because the amount of liability to each individual cannot be computed with reasonable accuracy. (This postpones for two additional years the effective date of Revenue Ruling 54-608.)

28. *Deduction of antitrust damage recoveries.*—Recoveries of antitrust and certain other damages are not to be taxed to the extent the related losses did not produce a tax benefit.

29. *Corporate stock redemptions with appreciated property.*—In general a corporation is to be taxed on the appreciation in value of property it uses to redeem stock from its shareholders.

30. *Reasonable accumulations by corporations.*—The Act gives protection from the special tax on accumulated earnings where a corporation accumulates amounts to redeem a deceased shareholder's stock to pay death taxes or to redeem stock from a private foundation which must be disposed of as an excess business holding under the Act.

31. *Insurance companies.*—The Act revises three aspects of the treatment of life insurance companies: the treatment of contingency reserves under group insurance contracts, the limitation on the carry-over of losses by an insurance company which changes the nature of its insurance business, and the application of the so-called phase III tax in the case of corporate spin-offs.

32. *Deferral of gain upon sale of certain low-income housing projects.*—Gain realized from certain sales of Federally assisted lower-income projects (so-called FHA 221(d) (3) and 236 projects) is deferred to the extent that the proceeds are reinvested within a specified time in other Federally assisted low-income projects which limit the rate of return.

33. *Cooperative per-unit retain allocations.*—A cooperative is permitted to deduct or exclude from gross income per-unit retain allocations paid during the 8½ month period following the close of the taxable year whether paid in money (or other property) or in qualified per-unit retain certificates.

34. *Inclusion of foster children in the definition of dependents.*—The Act permits a foster child (as is already true in the case of the taxpayer's own children) to have gross income in excess of the amount of the personal exemption (if the child is less than 19 years of age or is a student) without the taxpayer losing the dependency exemption for the child where he furnished more than half the support.

35. *Cooperative housing corporation.*—Income derived from a Governmental entity is not to be taken into consideration in determining whether individual tenant-stockholders of a cooperative housing corporation qualify for the deduction of their proportionate share of the interest and real estate taxes under the requirement that 80 percent of the corporation's income be derived from them.

36. *Replacement of converted real property.*—The Act extends to two years (from the previous one-year period) the automatic time period during which taxpayers may replace without recognition of gain, property which has been involuntarily converted.

37. *Change in reporting income on installment basis.*—Taxpayers are allowed to revoke retroactively an election to report on the installment basis by filing a notice of revocation within a specified time.

38. *Constructive sales price.*—Rules are provided for determining the tax base for *ad valorem* manufacturers' excise taxes in the case of sales to affiliated companies.

39. *Penalty for failure to pay tax or make deposits.*—The Act provides an additional charge of $\frac{1}{2}$ of one percent (up to 25 percent) of the amount owed for failure to pay income tax (other than estimated tax) when due, unless there is reasonable cause.

40. *Tax Court.*—The Tax Court is established as a court under Article I of the Constitution (instead of as an executive agency). A simplified, relatively informal procedure is provided for small claims cases.

41. *Miscellaneous provisions.*—The Act also deals with the treatment of mutual fund shares under periodic payment plans, the exception from foreign base company income where the purpose of the corporation and the transaction was not to achieve a substantial reduction in income taxes, the exemption of a portion of the taxpayer's salary, wages, or other income from levy to pay Federal taxes under certain conditions involving support payments for minor children, and a change in the dividends-paid deduction for purposes of computing the personal holding company deduction.

EXTENSION OF SURCHARGE AND EXCISES, TERMINATION OF INVESTMENT CREDIT, AND CERTAIN AMORTIZATION PROVISIONS

1. *Surcharge.*—The income tax surcharge was extended at a 5-percent rate from January 1, 1970, through June 30, 1970.

2. *Excises.*—The reductions in the excise taxes on passenger automobiles and communications services scheduled to begin on January 1, 1970, are postponed until January 1, 1971.

3. *Repeal of the investment credit.*—The investment credit is repealed with respect to property ordered or acquired after April 18, 1969. Property ordered under a binding contract before April 19, 1969, or on which substantial work had been completed before April 19, 1969, may receive the investment credit under certain transition rules.

4. *Pollution control facilities.*—Certified pollution control facilities with a normal useful life of 15 years or less which are added to plants in operation before January 1, 1969, may be amortized over a period of 60 months. This provision expires after December 31, 1974.

5. *Railroad rolling stock.*—Five-year amortization is provided for railroad rolling stock (including rolling stock leased to railroads by lessors) placed in service before January 1, 1975. Repairs to railroad rolling stock (except locomotives) are treated as deductible expenses if they do not exceed 20 percent of cost and 50-year amortization is provided for new railroad gradings and tunnel bores.

6. *Amortization of coal mine safety equipment.*—Five-year amortization is provided for certified coal mine safety equipment installed in order to comply with new Federal safety requirements and placed in service before January 1, 1975.

ADJUSTMENTS OF TAX BURDEN FOR INDIVIDUALS

1. *Increase in the personal exemption.*—The personal exemption is increased from \$600 to \$625 (\$650 from July 1 for tax withholding) in 1970, \$650 in 1971, \$700 in 1972, and \$750 in 1973 and later years.

2. *Percentage standard deduction.*—The percentage standard deduction is increased from 10 percent of adjusted gross income with a maximum of \$1,000 to 13 percent with a \$1,500 maximum in 1971, 14 percent with a \$2,000 maximum in 1972, and 15 percent with a \$2,000 maximum in 1973 and later years.

3. *Minimum standard deduction and low income allowance.*—The minimum standard deduction of \$200 plus \$100 per exemption is increased to \$1,100 in 1970, \$1,050 in 1971, and \$1,000 in 1972. In 1970 and 1971, the excess over the prior minimum standard deduction is reduced as income exceeds the nontaxable level (by \$1 for \$2 in 1970, and \$1 for \$15 in 1971). After 1971, the full \$1,000 minimum allowance will be available to all taxpayers.

4. *Filing requirement for individuals.*—The income level at which filing a tax return is required is raised for the years 1970, 1971, and 1972, from \$600 (\$1,200 for a taxpayer age 65 or over) to \$1,700 for a single person and \$2,300 for a married couple plus \$600 for each additional personal exemption to which the taxpayer is entitled on account of age. In 1973 and later years, these amounts are raised to \$1,750 for a single person and \$2,500 for a married couple plus \$750 for each age exemption. The filing requirement remains at \$600 for married couples filing separate returns until 1973 when it is raised to \$750.

5. *Tax treatment of single persons.*—A new tax rate schedule for single persons, effective in 1971, sets their tax liabilities at no more than 20 percent above those of married couples at the same taxable income levels. (Under prior law, the taxes of single persons could be 42 percent higher.) A new rate schedule for heads-of-households is approximately halfway between the new rate schedule for single persons and the rate schedule for joint returns. Married couples filing separate returns continue to use the prior law rate schedule for single persons.

6. *Maximum tax on earned income.*—The maximum marginal tax rate on taxable earned income is not to exceed 50 percent (compared to 70 percent on other income) after 1971. In 1971, the maximum rate is 60 percent. Earned income eligible for this limit is earned income reduced by tax preferences in excess of \$30,000.

7. *Withholding of income tax.*—Withholding is changed to reflect the changes in the personal exemption, the standard deduction, the tax

rates for single persons and the expiration of the surcharge as they become effective. New withholding procedures provide greater flexibility in withholding methods, broaden the allowance of additional withholding allowances for excess itemized deductions, exempt from withholding individuals who do not have a tax liability for the year, such as college students, provide for withholding on supplemental unemployment benefits, and allow voluntary withholding on certain types of payments such as pensions.

8. *Computation of tax by Internal Revenue Service.*—The income level below which a taxpayer may have his tax computed by the Internal Revenue Service is raised from \$5,000 to \$10,000 and the Service is permitted to make the procedure more generally available.

SOCIAL SECURITY BENEFITS

Regular OASDI benefits and those for certain individuals age 72 or over are increased 15 percent beginning in January 1970. The \$105 limitation on the wife's, husband's, widow's and widower's insurance benefits is eliminated so that the benefits in these cases are one-half the spouse's primary benefits.

II. REVENUE EFFECTS

Table 1 shows how the Tax Reform Act of 1969 has balanced tax reform and tax relief. Revenues from the tax reform program are expected to increase from \$1.2 billion in 1970 to \$3.3 billion when fully effective.¹ This is without regard to the revenue impact of repealing the investment credit, which increases revenues \$2.5 billion in 1970 and \$3.3 billion per year in the long run. Taken together, these revenue increases represent \$3.7 billion of additional revenue in 1970 and \$6.6 billion of additional revenue in the long run.

Against this reform program which raises revenue, the Reform Act has balanced a tax reduction program, which becomes fully effective in 1973. This accounts for a tax reduction of \$1.4 billion in 1970, \$4.9 billion in 1971, \$7.3 billion in 1972, and \$9.1 billion in 1973 and thereafter. The components of this tax-reduction program consist in 1973 of a tax reduction of \$2 billion in the form of a low-income allowance (or minimum standard deduction), an increase in the standard deduction accounting for \$1.6 billion, and an increase in the per capita exemption accounting for \$4.8 billion. Also, application of a maximum 50-percent rate on earned income accounts for a revenue loss of \$170 million. A further revenue loss of \$420 million is attributable to the reduced tax rate schedule made available for single persons.

TABLE 1.—BALANCING OF TAX REFORM AND TAX RELIEF UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172)—CALENDAR YEAR TAX LIABILITY, 1970-74 AND LONG RUN, 1969 LEVELS

	[In millions of dollars]					
	1970	1971	1972	1973	1974	Long run
Tax reform.....	+1,150	+1,430	+1,660	+1,905	+2,195	+3,320
Repeal of investment credit.....	+2,500	+2,990	+2,990	+3,040	+3,090	+3,300
Tax reform and repeal of investment credit....	+3,650	+4,420	+4,650	+4,945	+5,285	+6,620
Income tax relief:						
Low-income allowance.....	-625	-1,592	-2,057	-2,057	-2,057	-2,057
Increase in standard deduction *.....		-1,207	-1,355	-1,642	-1,642	-1,642
Increase in exemption.....	-816	-1,633	-3,267	-4,845	-4,845	-4,845
Maximum rate on earned income.....		-75	-170	-170	-170	-170
Tax treatment of single persons.....		-420	-420	-420	-420	-420
Total tax relief.....	-1,441	-4,927	-7,269	-9,134	-9,134	-9,134
Balance between reform (+) and relief (-).....	+2,209	-507	-2,619	-4,189	-3,849	-2,514
Extension of surcharge and excises.....	+4,270	+800	+800	+400		
Total.....	+6,479	+293	-1,819	-3,789	-3,849	-2,514

* 1971: 13 percent, \$1,500 ceiling; 1972: 14 percent, \$2,000 ceiling; 1973: 15 percent, \$2,000 ceiling.

¹ The estimates of the revenue effect of the Tax Reform Act presented in this summary are based on 1969 levels of income.

Table 2 shows, by adjusted gross income class, the aggregate individual income tax liability under prior law, the change in tax liability under the reform and relief provisions of the Act and the percentage tax change resulting from these provisions. The table indicates that under these provisions of the Act there will be an average 69.8-percent tax reduction for those in the zero to \$3,000 adjusted gross income class, a 33-percent reduction for those in the \$3,000 to \$5,000 adjusted gross income class, a reduction of almost 20 percent for those in the \$5,000 to \$7,000 adjusted gross income class, and a tax reduction in higher income classes beginning at 12.6 percent for incomes of \$10,000 to \$15,000 and gradually decreasing to 1.9 percent for incomes of \$50,000 to \$100,000. For income levels above \$100,000, because of the substantial impact of the tax-reform program, instead of a tax reduction there will be a tax increase of over 7 percent.

TABLE 2.—INDIVIDUAL INCOME TAX LIABILITY—TAX IN 1969 UNDER PRIOR LAW AND AMOUNT AND PERCENTAGE OF CHANGE UNDER REFORM AND RELIEF PROVISIONS OF THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), WHEN FULLY EFFECTIVE, 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class	Tax under prior law ¹ (millions)	Increase (+) decrease (-) from reform and relief provisions	
		Amount (millions)	Percentage
0 to \$3,000.....	\$1,169	-\$816	-69.8
\$3,000 to \$5,000.....	3,320	-1,101	-33.2
\$5,000 to \$7,000.....	5,591	-1,112	-19.9
\$7,000 to \$10,000.....	11,792	-1,859	-15.8
\$10,000 to \$15,000.....	18,494	-2,327	-12.6
\$15,000 to \$20,000.....	9,184	-791	-8.6
\$20,000 to \$50,000.....	13,988	-715	-5.1
\$50,000 to \$100,000.....	6,659	-128	-1.9
\$100,000 and over.....	7,686	+557	+7.2
Total.....	77,884	-8,294	-10.6

¹ Exclusive of tax surcharge.

Note: Details do not necessarily add to totals because of rounding.

Table 3 is a schematic outline of the individual income tax relief provisions under the Act for each of the calendar years 1970, 1971, 1972, and 1973 and thereafter. As table 4 shows, the minimum standard deduction (or low-income allowance) evolves in three stages to a flat \$1,000 minimum standard deduction effective for 1972 and thereafter; the percentage standard deduction likewise develops in three stages to a 15-percent standard deduction with a \$2,000 ceiling for 1973 and thereafter; the personal exemption increases in four steps to \$750 per capita for 1973 and thereafter; the maximum tax rate on earned income comes into being in 1971 at 60 percent and drops to 50 percent for 1972 and thereafter; and the revised tax treatment of single persons becomes effective for 1971 and thereafter by reduction to a level no greater than 120 percent of the joint return tax with the same taxable income.

TABLE 3.—INDIVIDUAL INCOME TAX RELIEF PROVISIONS UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), CALENDAR YEARS 1970-73 AND THEREAFTER

Calendar year	Minimum standard deduction	Percentage standard deduction	Personal exemption	Maximum tax rate on earned income (percent)	Treatment of single persons
1970.....	¹ \$1, 100	.....	² \$625	.....	.....
1971.....	³ \$1, 050 1:2	13 percent (\$1,500 ceiling).....	\$650	60	(*)
1972.....	1:15 \$1, 000	14 percent (\$2,000 ceiling).....	\$700	50	(*)
1973 and thereafter...	\$1, 000	15 percent (\$2,000 ceiling).....	\$750	50	(*)

¹ This low-income allowance, or minimum standard deduction, is phased out by reducing the additional allowance (difference between the 1969 minimum standard deduction and \$1,100) by \$1 for every \$2 of adjusted gross income in excess of the 1970 nontaxable level.

² For the year on a liability basis; \$650 from July 1 for withholding purposes.

³ This minimum standard deduction is phased out by reducing the additional allowance (difference between the 1969 minimum standard deduction and \$1,050) by \$1 for every \$15 of adjusted gross income in excess of the 1971 nontaxable level.

⁴ Tax no greater than 120 percent of joint return tax with same taxable income.

Table 4 shows the source of the tax relief under the Act for each income level combined with the impact of the reform revenue-increasing provisions. This table indicates, for example, that most of the income tax relief for those in the lowest income class, as might be expected, is attributable to the low-income allowance. For those in the \$3,000 to \$7,000 classes the primary relief occurs as a result of the low-income allowance coupled with the increased per capita exemption. In the \$7,000 to \$10,000 class, the increase in the per capita exemption and in the standard deduction are the important factors accounting for the reduction. For the \$10,000 to \$15,000 class, where the largest dollar reduction occurs, the most significant factors accounting for relief are also the increase in the per capita exemption and the increase in the standard deduction.

For income levels above \$15,000, the standard deduction increase gradually becomes less significant, and the increased exemption accounts for the major part of the reductions until the \$100,000 and over class is reached.

TABLE 4.—INDIVIDUAL INCOME TAX LIABILITY—TAX RELIEF PROVISIONS AFFECTING INDIVIDUALS AND TOTAL FOR ALL REFORM AND RELIEF PROVISIONS AFFECTING INDIVIDUALS UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), WHEN FULLY EFFECTIVE, 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class	Relief provisions						Total relief provisions	Total, all provisions
	Reform provisions	Low income allowance	\$750 exemption	15-percent \$2,000 standard deduction	Maximum tax on earned income	Tax treatment of single persons		
	(millions)							
0 to \$3,000.....	+\$6	-\$682	-\$140				-\$822	-\$816
\$3,000 to \$5,000.....	-6	-719	-366	-\$10			-1,095	-1,101
\$5,000 to \$7,000.....	-4	-458	-612	-31		-\$7	-1,108	-1,112
\$7,000 to \$10,000.....	-5	-198	-1,244	-366		-45	-1,853	-1,858
\$10,000 to \$15,000.....	+6		-1,407	-858		-68	-2,333	-2,327
\$15,000 to \$20,000.....	-7		-480	-242		-62	-784	-791
\$20,000 to \$50,000.....	+56		-462	-125	-\$5	-179	-771	-715
\$50,000 to \$100,000.....	+54		-104	-8	-30	-40	-182	-128
\$100,000 and over.....	+740		-30	-1	-135	-17	-183	+557
Total.....	+840	-2,057	-4,845	-1,642	-170	-420	-9,134	-8,294

Note: Details do not necessarily add to totals because of rounding.

Table 5 presents a breakdown of the impact of each of the reform provisions by income levels. As is shown by this table, by far the greater portion of the reform provisions have their effect at income levels of \$100,000 and over. This accounts for the overall net increase in tax liability for this income group as shown in table 2, while net reductions are provided for the other groups.

TABLE 5.—INDIVIDUAL INCOME TAX LIABILITY—TAX REFORM PROVISIONS AFFECTING INDIVIDUALS UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), WHEN FULLY EFFECTIVE, 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class	Change alternative tax on long-term gains ¹	Capital loss limitation	Pension provision	Life estates provision	Averaging including capital gains and 120 percent	Charitable deductions	Interest deduction	Reduced percentage depletion	Accumulation trusts	Moving expenses	Farm losses	Real estate	Tax-free dividends	Tax on preference income	Citrus grove costs	Total
0 to \$3,000.....	+\$5	(?)	.....	(?)	.....	.....	.....	(?)	-\$1	.....	(?)	(?)	+\$2	.....	+\$6
\$3,000 to \$5,000.....	+3	+\$1	.....	(?)	.....	.....	.....	+\$1	-12	.....	(?)	(?)	(?)	.....	-6
\$5,000 to \$7,000.....	+5	+2	.....	(?)	.....	.....	.....	+1	-14	.....	(?)	.....	(?)	.....	-4
\$7,000 to \$10,000.....	+9	+3	.....	(?)	.....	.....	.....	+1	-26	.....	+\$5	.....	(?)	.....	-3
\$10,000 to \$15,000.....	+15	+8	.....	-35	.....	.....	.....	+3	-32	.....	+10	.....	(?)	.....	+6
\$15,000 to \$20,000.....	+18	+5	.....	-30	.....	.....	.....	+3	-11	.....	+10	.....	(?)	.....	-7
\$20,000 to \$50,000.....	+16	+14	.....	-110	.....	.....	.....	+5	-12	.....	+42	.....	(?)	.....	+96
\$50,000 to \$100,000.....	+4	+8	.....	+5	.....	.....	.....	+7	-2	.....	+47	.....	.....	.....	+54
\$100,000 and over.....	(?)	+19	+5	-50	.....	.....	.....	+28	(?)	.....	+131	.....	.....	.....	+740
Total.....	+275	+65	+60	+10	-300	+20	+20	+40	+115	-110	+25	+245	+80	+285	+10	+840

¹ Assumes 1/2 of effect as compared with no change in realization.

² Less than \$500,000.

(millions)

Table 6 shows, by adjusted gross income class, the number of individual income tax returns rendered nontaxable by the relief provisions of the Act. In total some 7.6 million returns will be rendered nontaxable by the relief provisions when they are fully effective in 1973.

TABLE 6.—TAXABLE INDIVIDUAL INCOME TAX RETURNS UNDER PRIOR LAW AND NUMBER MADE NONTAXABLE BY THE RELIEF PROVISIONS OF THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), WHEN FULLY EFFECTIVE, ¹ 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

[Number of returns in thousands]

Adjusted gross income class	Returns taxable under prior law	Returns made non-taxable by low-income allowance, 15 percent \$2,000 standard deduction and \$750 exemption	Returns remaining taxable—but benefiting from the relief provisions
0 to \$3,000.....	10,053	5,846	4,207
\$3,000 to \$5,000.....	9,562	1,131	8,431
\$5,000 to \$7,000.....	9,779	424	9,355
\$7,000 to \$10,000.....	13,815	172	13,643
\$10,000 to \$15,000.....	13,062	28	13,034
\$15,000 to \$20,000.....	3,852	2	3,850
\$20,000 to \$50,000.....	2,594	-----	2,594
\$50,000 to \$100,000.....	340	-----	340
\$100,000 and over.....	95	-----	95
Total.....	63,152	7,603	55,549

¹ Provisions effective for tax year 1973 and thereafter.

Table 7 sets forth, by adjusted gross income class, the impact of the standard deduction provisions of the Act when fully effective in 1973. The standard deduction provisions reduce tax for 68.6 percent of all taxable returns with heavy concentration of the returns with reductions in the lower income classes. These provisions also increase the percentage of all returns, taxable and nontaxable, using the standard deduction from 58.2 percent to 72.8 percent.

TABLE 7.—PROPORTION OF INDIVIDUAL INCOME TAX RETURNS WITH STANDARD DEDUCTION UNDER PRIOR LAW, PROPORTION OF RETURNS WITH TAX DECREASE AND PROPORTION OF RETURNS WITH STANDARD DEDUCTION UNDER THE STANDARD DEDUCTION PROVISIONS OF THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), WHEN FULLY EFFECTIVE,¹ 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

[Number of returns in thousands]

Adjusted gross income class	Prior law		Percent of all returns with standard deduction	Tax Reform Act of 1969	
	All returns ²	Taxable returns		Percent of prior law taxable returns with tax decrease	Percent of all returns with standard deduction ³
0 to \$3,000.....	21,318	10,053	92.7	99.3	97.7
\$3,000 to \$5,000.....	10,582	9,562	74.7	89.1	88.1
\$5,000 to \$7,000.....	10,006	9,779	60.6	73.8	72.7
\$7,000 to \$10,000.....	13,867	13,815	42.4	59.0	59.4
\$10,000 to \$15,000.....	13,087	13,062	27.8	56.0	55.9
\$15,000 to \$20,000.....	3,853	3,852	15.3	39.4	39.5
\$20,000 to \$50,000.....	2,600	2,594	8.7	22.9	23.4
\$50,000 to \$100,000.....	340	340	2.9	6.5	6.5
\$100,000 and over.....	95	95	1.0	2.1	2.1
Total.....	75,748	63,152	58.2	68.6	72.8

¹ In 1973 and thereafter: minimum standard deduction of \$1,000 and percentage standard deduction of 15 percent with a \$2,000 limit; excludes effect of \$750 exemption.

² Taxable and nontaxable returns.

³ Without regard to decrease in returns due to higher filing requirement.

Table 8 shows the increase or decrease in income tax liability produced by each of the reform provisions and by repeal of the investment credit, for calendar years 1970-74 and for the long run, broken down by individual income tax returns and corporate income tax returns.

TABLE 8.—INCOME TAX LIABILITY—TAX REFORM PROVISIONS UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), BY CORPORATE AND INDIVIDUAL INCOME TAX LIABILITY, CALENDAR YEARS 1970-74 AND LONG RUN, 1969 LEVELS¹

Provision	Individual income tax liability					Corporate income tax liability						
	1970	1971	1972	1973	1974	Long run	1970	1971	1972	1973	1974	Long run
[In millions of dollars]												
Title I.—Tax-exempt organizations:												
Private foundations.....												
Unrelated business income.....												
Title II.—Individual deductions:												
Charitable contributions.....	5	10	20	20	20	20						20
Farm losses, etc.....	(-)	5	10	10	10	10						25
Capitalization of citrus grove expenses.....	5	10	10	10	10	10						10
Interest.....			20	20	20	20						20
Moving expenses.....	-110	-110	-110	-110	-110	-110						-110
Title III.—Tax on preference income; adjustments primarily affecting individuals:												
Tax on preference income.....	290	290	285	285	285	285						285
Income averaging.....	-300	-300	-300	-300	-300	-300						-300
Deferred compensation.....	(?)	(?)	(?)	(?)	(?)	(?)						(?)
Accumulation trusts.....	10	25	35	45	55	115						(?)
Title IV.—Adjustments primarily affecting corporations:												
Multiple corporations.....							25	60	100	140	195	235
Corporate mergers, etc.....							5	10	15	20	25	40
Stock dividends.....	(?)	(?)	(?)	(?)	(?)	(?)						
Financial institutions:												
Commercial banks:												
Reserves.....							225	150	125	100	100	250
Capital gains.....							5	10	15	20	25	50
Mutual thrift reserves:												
Savings and loan associations.....							20	35	45	55	60	85
Mutual savings banks.....							25	25	30	30	30	35
Regulated utilities.....							60	140	185	225	260	310
Tax-free dividends.....				80	80	80						

Title V—Adjustments affecting individuals and corporations:

Natural resources.....	40	40	40	40	40	195	195	195	195	195	195	195
Percentage depletion.....						100	110	125	140	150	200	200
Production payments.....						(²)	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})
Foreign depletion.....												
Capital gains and losses:												
Increase in alternative tax.....	\$ 165	\$ 220	\$ 275	\$ 275	\$ 275	\$ 275	\$ 275	105	175	175	175	175
Individual capital loss provisions.....	50	50	55	60	65	(²)	(²)					
Sale of papers, etc.....	(²)	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})					
Pension plans.....	(²)	5	10	15	20	60	60					
Life estates.....	10	10	10	10	10	10	10					
Casualty loss.....	(²)	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})					
Franchises.....	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(²)					
Real estate depreciation:												
Used property ^{1,4}	5	20	55	100	145	315	315	10	85	185	315	450
New housing ^{1,4}												
Capital gain, recapture.....												
Rehabilitation ^{1,4}	-5	-10	-20	-30	-40	-70	-70	-10	-40	-80	-120	-260
Subchapter S corporations: Certain pension plans.....		(²)	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})					
Title VII—Amortization:												
Pollution control facilities ³												
Railroad property ^{3,4}.....	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(^{2})	(²)					
Title IX—Miscellaneous provisions: Exemption for foster children.....												
								-15	-40	-70	-95	-120
								-105	-95	-140	-195	-85
Total tax reform.....	165	265	395	530	580	840	840	985	1,165	1,265	1,375	2,480
Title VII—Investment credit ⁶	600	600	600	600	600	600	600	1,900	2,390	2,390	2,440	2,700
Total, tax reform and investment credit.....	765	865	995	1,130	1,180	1,440	1,440	2,885	3,555	3,655	3,815	5,180

¹ Except as indicated these estimates are all at 1969 levels, the time difference being solely to show the phase-in.

² Assumes 1/4 of effect as compared with no change in realization.

³ Less than \$2,500,000.

⁴ The figures in the "long run" columns are for 1979.

⁴ Assumes growth.

⁵ Assumes 1/4 of effect as compared with no change in realization.

⁶ Calendar year 1969 estimates: individual income tax liability, \$400,000,000; corporate income tax liability, \$500,000,000.

Table 9 gives, for 1969 under prior law and for 1970, 1971, 1972, and 1973 under the Act, the individual income tax burden of the single person with adjusted gross income ranging from \$900 to \$25,000, assuming first that the taxpayer has deductions equal to 10 percent of adjusted gross income (pt. A of the table) and then that the taxpayer has deductions equal to 18 percent of adjusted gross income (pt. B of the table). Table 10 presents similar data for the married couple with no dependents.

TABLE 9.—TAX BURDEN ON THE SINGLE PERSON IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER

A. ASSUMING NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME¹

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage ³
1. 1969² AND 1970³				
\$900.....	0	0	0	0
\$1,700.....	\$115	0	\$115	100.0
\$1,725.....	119	0	119	100.0
\$1,750.....	123	\$5	118	95.9
\$3,000.....	362	302	60	16.6
\$3,500.....	457	420	37	8.1
\$4,000.....	550	507	43	7.8
\$5,000.....	738	683	55	7.5
\$7,500.....	1,285	1,190	95	7.4
\$10,000.....	1,916	1,778	138	7.2
\$12,500.....	2,638	2,450	188	7.1
\$15,000.....	3,469	3,224	245	7.1
\$17,500.....	4,399	4,089	310	7.0
\$20,000.....	5,410	5,031	379	7.0
\$25,000.....	7,680	7,144	536	7.0
2. 1969² AND 1971				
\$900.....	0	0	0	0
\$1,700.....	\$115	0	\$115	100.0
\$1,725.....	119	\$4	115	96.6
\$1,750.....	123	7	116	94.3
\$3,000.....	362	207	155	42.8
\$3,500.....	457	296	161	35.2
\$4,000.....	550	396	154	28.0
\$5,000.....	738	599	139	18.8
\$7,500.....	1,285	1,084	201	15.6
\$10,000.....	1,916	1,603	313	16.3
\$12,500.....	2,638	2,185	453	17.2
\$15,000.....	3,469	2,877	592	17.1
\$17,500.....	4,399	3,551	848	19.3
\$20,000.....	5,410	4,289	1,121	20.7
\$25,000.....	7,680	5,933	1,747	22.7
3. 1969² AND 1972				
\$900.....	0	0	0	0
\$1,700.....	\$115	0	\$115	100.0
\$1,725.....	119	\$4	115	96.6
\$1,750.....	123	7	116	94.3
\$3,000.....	362	193	169	46.7
\$3,500.....	457	276	181	39.6
\$4,000.....	550	367	183	33.3
\$5,000.....	738	557	181	24.5
\$7,500.....	1,285	1,058	227	17.7
\$10,000.....	1,916	1,566	350	18.3
\$12,500.....	2,638	2,104	534	20.2
\$15,000.....	3,469	2,717	752	21.7
\$17,500.....	4,399	3,458	941	21.4
\$20,000.....	5,410	4,272	1,138	21.0
\$25,000.....	7,680	5,914	1,766	23.0

See footnotes at end of table, p. 24.

TABLE 9.—TAX BURDEN ON THE SINGLE PERSON IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER—Continued

A. ASSUMING NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME¹—Continued

4. 1969² AND 1973 AND THEREAFTER

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage
\$900.....	0	0	0	0
\$1,700.....	\$115	0	\$115	100.0
\$1,725.....	119	0	119	100.0
\$1,750.....	123	0	123	100.0
\$3,000.....	362	\$185	177	48.9
\$3,500.....	457	268	189	41.4
\$4,000.....	550	358	192	34.9
\$5,000.....	738	548	190	25.7
\$7,500.....	1,285	1,031	254	19.8
\$10,000.....	1,916	1,530	386	20.1
\$12,500.....	2,638	2,059	579	21.9
\$15,000.....	3,469	2,703	766	22.1
\$17,500.....	4,399	3,443	956	21.7
\$20,000.....	5,410	4,255	1,155	21.3
\$25,000.....	7,680	5,895	1,785	23.2

B. ASSUMING NONBUSINESS DEDUCTIONS OF 18 PERCENT OF INCOME¹

1. 1969² AND 1970³

\$900.....	0	0	0	0
\$1,700.....	\$114	0	\$114	100.0
\$1,725.....	117	0	117	100.0
\$1,750.....	120	\$5	115	95.8
\$3,000.....	314	289	25	8.0
\$3,500.....	397	366	31	7.8
\$4,000.....	483	445	38	7.9
\$5,000.....	655	605	50	7.6
\$7,500.....	1,134	1,052	82	7.2
\$10,000.....	1,683	1,562	121	7.2
\$12,500.....	2,301	2,137	164	7.1
\$15,000.....	3,007	2,794	213	7.1
\$17,500.....	3,806	3,537	269	7.1
\$20,000.....	4,677	4,348	329	7.0
\$25,000.....	6,628	6,164	464	7.0

2. 1969² AND 1971

\$900.....	0	0	0	0
\$1,700.....	\$114	0	\$114	100.0
\$1,725.....	117	\$4	113	96.6
\$1,750.....	120	7	113	94.2
\$3,000.....	314	207	107	34.1
\$3,500.....	397	296	101	25.4
\$4,000.....	483	396	87	18.0
\$5,000.....	655	586	69	10.5
\$7,500.....	1,134	1,005	129	11.4
\$10,000.....	1,683	1,482	201	11.9
\$12,500.....	2,301	1,990	311	13.5
\$15,000.....	3,007	2,536	471	15.7
\$17,500.....	3,806	3,123	683	17.9
\$20,000.....	4,677	3,753	924	19.8
\$25,000.....	6,628	5,176	1,452	21.9

3. 1969² AND 1972

\$900.....	0	0	0	0
\$1,700.....	\$114	0	\$114	100.0
\$1,725.....	117	\$4	113	96.6
\$1,750.....	120	7	113	94.2
\$3,000.....	314	193	121	38.5
\$3,500.....	397	276	121	30.5
\$4,000.....	483	367	116	24.0
\$5,000.....	655	557	98	15.0
\$7,500.....	1,134	995	139	12.3
\$10,000.....	1,683	1,470	213	12.7
\$12,500.....	2,301	1,978	323	14.0
\$15,000.....	3,007	2,522	485	16.1
\$17,500.....	3,806	3,109	697	18.3
\$20,000.....	4,677	3,737	940	20.1
\$25,000.....	6,628	5,158	1,470	22.2

See footnotes at end of table, p. 24.

TABLE 9.—TAX BURDEN ON THE SINGLE PERSON IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER—Continued

B. ASSUMING NONBUSINESS DEDUCTIONS OF 18 PERCENT OF INCOME¹—Continued

4. 1969² AND 1973 AND THEREAFTER

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage
\$900.....	0	0	0	
\$1,700.....	\$114	0	\$114	100.0
\$1,725.....	117	0	117	100.0
\$1,750.....	120	0	120	100.0
\$3,000.....	314	\$185	129	41.1
\$3,500.....	397	268	129	32.5
\$4,000.....	483	358	125	25.9
\$5,000.....	655	548	107	16.3
\$7,500.....	1,134	984	150	13.2
\$10,000.....	1,683	1,458	225	13.4
\$12,500.....	2,301	1,965	336	14.6
\$15,000.....	3,007	2,509	498	16.6
\$17,500.....	3,806	3,094	712	18.7
\$20,000.....	4,677	3,722	955	20.4
\$25,000.....	6,628	5,140	1,488	22.5

¹ These burdens have been computed without use of the optional tax table.

² Including 10 percent tax surcharge.

³ Including 2.5 percent tax surcharge.

TABLE 10.—TAX BURDEN ON THE MARRIED COUPLE WITH NO DEPENDENTS IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER

A. ASSUMING NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME¹

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage
1. 1969 ² AND 1970 ³				
\$1,600.....	0	0	0	0
\$2,350.....	\$105	0	\$105	100.0
\$2,400.....	112	\$11	101	90.2
\$2,500.....	126	32	94	74.6
\$3,000.....	200	137	63	31.5
\$3,500.....	275	249	26	9.5
\$4,000.....	367	349	18	4.9
\$5,000.....	543	503	40	7.4
\$7,500.....	1,007	928	79	7.8
\$10,000.....	1,476	1,366	110	7.5
\$12,500.....	2,014	1,866	148	7.3
\$15,000.....	2,569	2,381	188	7.3
\$17,500.....	3,188	2,957	231	7.2
\$20,000.....	3,832	3,557	275	7.2
\$25,000.....	5,276	4,900	376	7.1
2. 1969 ² AND 1971				
\$1,600.....	0	0	0	0
\$2,350.....	\$105	0	\$105	100.0
\$2,400.....	112	\$7	105	93.8
\$2,500.....	126	22	104	82.5
\$3,000.....	200	97	103	51.5
\$3,500.....	275	174	101	36.7
\$4,000.....	367	254	113	30.8
\$5,000.....	543	422	121	22.3
\$7,500.....	1,007	853	154	15.3
\$10,000.....	1,476	1,266	210	14.2
\$12,500.....	2,014	1,754	260	12.9
\$15,000.....	2,569	2,310	259	10.1
\$17,500.....	3,188	2,873	315	9.9
\$20,000.....	3,832	3,456	376	9.8
\$25,000.....	5,276	4,764	512	9.7

See footnotes at end of table p. 26.

TABLE 10.—TAX BURDEN ON THE MARRIED COUPLE WITH NO DEPENDENTS IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER—Continued

A. ASSUMING NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME 1—Continued

3. 1969² AND 1972

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage
\$1,600.....	0	0	0	0
\$2,350.....	\$105	0	\$105	100.0
\$2,400.....	112	0	112	100.0
\$2,500.....	126	\$14	112	88.9
\$3,000.....	200	84	116	58.0
\$3,500.....	275	155	120	43.6
\$4,000.....	367	230	137	37.3
\$5,000.....	543	386	157	28.9
\$7,500.....	1,007	820	187	18.6
\$10,000.....	1,476	1,228	248	16.8
\$12,500.....	2,014	1,677	337	16.7
\$15,000.....	2,569	2,172	397	15.5
\$17,500.....	3,188	2,785	403	12.6
\$20,000.....	3,832	3,428	404	10.5
\$25,000.....	5,276	4,732	544	10.3

4. 1969² AND 1973 AND THEREAFTER

\$1,600.....	0	0	0	0
\$2,350.....	\$105	0	\$105	100.0
\$2,400.....	112	0	112	100.0
\$2,500.....	126	0	126	100.0
\$3,000.....	200	\$70	130	65.0
\$3,500.....	275	140	135	49.1
\$4,000.....	367	215	152	41.4
\$5,000.....	543	370	173	31.9
\$7,500.....	1,007	786	221	21.9
\$10,000.....	1,476	1,190	286	19.4
\$12,500.....	2,014	1,628	386	19.2
\$15,000.....	2,569	2,150	419	16.3
\$17,500.....	3,188	2,760	428	13.4
\$20,000.....	3,832	3,400	432	11.3
\$25,000.....	5,276	4,700	576	10.9

B. ASSUMING NONBUSINESS DEDUCTIONS OF 18 PERCENT OF INCOME 1

1. 1969² AND 1970³

\$1,600.....	0	0	0	0
\$2,350.....	\$102	0	\$102	100.0
\$2,400.....	108	\$11	97	89.8
\$2,500.....	119	32	87	73.1
\$3,000.....	179	137	42	23.5
\$3,500.....	241	233	8	3.3
\$4,000.....	306	295	11	3.6
\$5,000.....	463	433	30	6.5
\$7,500.....	881	811	70	7.9
\$10,000.....	1,309	1,211	98	7.5
\$12,500.....	1,772	1,640	132	7.4
\$15,000.....	2,268	2,102	166	7.3
\$17,500.....	2,803	2,598	205	7.3
\$20,000.....	3,366	3,124	242	7.2
\$25,000.....	4,602	4,274	328	7.1

See footnotes at end of table, p. 26.

TABLE 10.—TAX BURDEN ON THE MARRIED COUPLE WITH NO DEPENDENTS IN 1969 AND, UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), IN 1970-73 AND THEREAFTER—Continued

B. ASSUMING NONBUSINESS DEDUCTIONS OF 18 PERCENT OF INCOME¹—Continued2. 1969² AND 1971

Adjusted gross income (wages and salaries)	Tax in 1969 ²	Tax under Public Law 91-172	Tax decrease	
			Amount	Percentage
\$1,600	0	0	0	0
\$2,350	\$102	0	\$102	100.0
\$2,400	108	\$7	101	93.5
\$2,500	119	22	97	81.5
\$3,000	179	97	82	45.8
\$3,500	241	174	67	27.8
\$4,000	306	254	52	17.0
\$5,000	463	418	45	9.7
\$7,500	881	782	99	11.2
\$10,000	1,309	1,171	138	10.5
\$12,500	1,772	1,589	183	10.3
\$15,000	2,268	2,040	228	10.1
\$17,500	2,803	2,523	280	10.0
\$20,000	3,366	3,035	331	9.8
\$25,000	4,602	4,156	446	9.7

3. 1969² AND 1972

\$1,600	0	0	0	0
\$2,350	\$102	0	\$102	100.0
\$2,400	108	0	108	100.0
\$2,500	119	\$14	105	88.2
\$3,000	179	84	95	53.1
\$3,500	241	155	86	35.7
\$4,000	306	230	76	24.8
\$5,000	463	386	77	16.6
\$7,500	881	763	118	13.4
\$10,000	1,309	1,152	157	12.0
\$12,500	1,772	1,567	205	11.6
\$15,000	2,268	2,018	250	11.0
\$17,500	2,803	2,498	305	10.9
\$20,000	3,366	3,010	356	10.6
\$25,000	4,602	4,128	474	10.3

4. 1969² AND 1973 AND THEREAFTER

\$1,600	0	0	0	0
\$2,350	\$102	0	\$102	100.0
\$2,400	108	0	108	100.0
\$2,500	119	0	119	100.0
\$3,000	179	\$70	109	60.9
\$3,500	241	140	101	41.9
\$4,000	306	215	91	29.7
\$5,000	463	370	93	20.1
\$7,500	881	744	137	15.6
\$10,000	1,309	1,133	176	13.4
\$12,500	1,772	1,545	227	12.8
\$15,000	2,268	1,996	272	12.0
\$17,500	2,803	2,473	330	11.8
\$20,000	3,366	2,985	381	11.3
\$25,000	4,602	4,100	502	10.9

¹ These burdens have been computed without use of the optional tax table.² Including 10 percent tax surcharge.³ Including 2.5 percent tax surcharge.

Table 11 indicates the effect on fiscal year receipts for each year 1970 through 1975 of the provisions of the Act apart from the social security provisions; the calendar and fiscal year impact of the latter are set forth in table 12.

TABLE 11.—EFFECT OF THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), FISCAL YEAR RECEIPTS, 1970-75, 1969 LEVELS

[In billions]

Provision	Fiscal year					
	1970	1971	1972	1973	1974	1975
Tax reform provisions (+):						
Corporation ¹	+\$0.2	+\$0.9	+\$1.2	+\$1.3	+\$1.4	+\$1.6
Individual ¹	(?)	+2	+3	+4	+5	+6
Total, tax reform provisions.....	+2	+1.1	-1.5	+1.7	+1.9	+2.2
Tax relief provisions (-):						
Individual ²	-3	-3.1	-5.9	-8.0	-9.1	-9.1
Other provisions (+):						
Repeal of investment credit:						
Corporation.....	+9	+1.9	+2.3	+2.4	+2.4	+2.5
Individual.....	+4	+6	+6	+6	+6	+6
Total, repeal of investment credit.....	+1.3	+2.5	+2.9	+3.0	+3.0	+3.1
Extension of tax surcharge:						
Corporation.....	+3	+7				
Individual.....	+1.7	+4				
Total, surcharge extension.....	+2.0	+1.1				
Extension of excise taxes.....	+5	+1.1	+8	+6	+2	
Total, other provisions.....	+3.8	+4.7	+3.7	+3.6	+3.2	+3.1
Total, all provisions.....	+3.7	+2.7	-7	-2.7	-4.0	-3.8

¹ Does not reflect the increase in tax receipts resulting from the imposition of increased penalties for failure to pay tax and make deposits when due.

² Less than \$50,000,000.

³ Does not reflect \$200,000,000 reduction in receipts resulting from certification of nontaxability for withholding tax purposes.

TABLE 12.—EFFECT OF MAJOR SOCIAL SECURITY AMENDMENTS UNDER THE TAX REFORM ACT OF 1969 (PUBLIC LAW 91-172), CALENDAR AND FISCAL YEARS 1970-74, 1969 LEVELS

[In billions]

	1970	1971	1972	1973	1974
Calendar years: Benefits.....	\$3.9	\$4.4	\$4.4	\$4.4	\$4.4
Fiscal years: Benefits.....	1.8	4.3	4.4	4.4	4.4

III. GENERAL EXPLANATION

A. PRIVATE FOUNDATIONS

1. Excise Tax on Investment Income (sec. 101(b) of the Act and sec. 4940 of the code)

Prior law.—Under prior law, the investment income of private foundations qualifying as exempt organizations was not subject to any tax. Many exempt organizations were taxed on their unrelated business income, but this tax did not apply to investment income.

General reasons for change.—The Congress has concluded that private foundations should share some of the burden of paying the cost of government, especially for more extensive and vigorous enforcement of the tax laws relating to exempt organizations.

However, the Congress believes that private foundations should continue to be exempt from income tax. Accordingly, the Act casts the charge or audit fee for private foundations in the form of an excise tax with respect to the carrying on of the organization's activities, rather than as a tax under chapter 1 of the Internal Revenue Code.

Explanation of provisions.—The Act imposes an excise tax of 4 percent upon a private foundation's net investment income. The income subject to this tax includes interest (other than exempt State and municipal bond interest), dividends, rents, and royalties, less the expenses paid or incurred in earning such income. The corporate dividends received deduction is not allowed. Depreciation is limited to straight line and depletion is limited to cost. Certain capital gains are included in full in the base for this tax. Capital losses are allowed only to the extent of gains. Unrelated business income is already taxable under the income tax provisions and so is excluded from the base of this excise tax.

In computing capital gains and losses, the basis for determining gain of property held by the foundation on December 31, 1969 (and continuously thereafter to the date of its disposition) is not less than the fair market value on that date. However, if the usual basis rules produce a higher basis, then they apply. Also, capital gains and losses are taken into account only if incurred on assets used to produce income subject to this tax or used to produce unrelated business income (except to the extent such gains and losses are used to compute the tax on unrelated business income).

If a private foundation loses its exempt status (for example, where an existing foundation fails to take the necessary steps to reform its governing instrument, as described below in *Prohibitions Against Self-Dealing*), then it is subject to the regular income tax provisions.¹ If the sum of the special excise tax on investment income and the tax on unrelated business income (applicable to exempt private foundations) exceeds the regular income tax, then a nonexempt foundation must pay

¹ However, if the private foundation has been organized as a trust, it is not entitled to the unlimited charitable contribution deduction generally available to trusts.

the amount of this excess. This is to insure that a private foundation cannot reduce its liability for internal revenue taxes by losing its exempt status.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

Revenue effect.—The revenue increases under these amendments are estimated at \$35 million in the first year, \$45 million in the fifth year, and \$55 million in the tenth year of operation.

2. Prohibitions Against Self-Dealing (sec. 101(b), (a), (c), (f), (g), (h), and (i) of the Act and secs. 4941, 507, 508, 4946, 6213, 6501, 6511, 6684, and 7454 of the code)

Prior law.—The existing law (sec. 501(c)(3), unchanged by the Reform Act) imposes upon every organization qualifying as an educational, charitable, religious, etc., organization the requirement that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual * * *.”

The 1950 amendments to the exempt organizations provisions (sec. 503 of the 1954 Code), specify a number of prohibited types of self-dealing transactions which apply to categories of organizations which include what are now called “private foundations”. Arm’s-length standards are imposed with regard to loans, payments of compensation, preferential availability of services, substantial purchases or sales, and substantial diversions of income or corpus to (or from, as the case may be) creators (of trusts) and substantial donors and their families and controlled corporations.

The sanctions provided are loss of exemption for a minimum of one taxable year, and loss of charitable contributions deductions under certain circumstances.

General reasons for change.—Arm’s-length standards have proved to require disproportionately great enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. On occasion the sanctions are ineffective and tend to discourage the expenditure of enforcement effort. On the other hand, in many cases the sanctions are so great in comparison to the offense involved, that they cause reluctance in enforcement, especially in view of the element of subjectivity in applying arm’s-length standards. Where the Internal Revenue Service does seek to apply sanctions in such circumstances, the same factors encourage extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.

Consequently, as a practical matter, prior law did not preserve the integrity of private foundations. Also, the Congress concluded that compliance with arm’s-length standards often does not in itself prevent the use of a private foundation to improperly benefit those who control the foundation. This is true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs cash and cannot find a ready buyer; (2) lends money to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternate sources of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of the property.

To minimize the need to apply subjective arm’s-length standards, to avoid the temptation to misuse private foundations for noncharita-

ble purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the Act generally prohibits self-dealing transactions and provides a variety and graduation of sanctions, as described below. This is based on the belief by the Congress that the highest fiduciary standards require complete elimination of all self-dealing rather than arm's-length standards.²

Explanation of provisions.—The Act removes private foundations from the present arm's-length self-dealing requirements (sec. 503) and, in place of those limitations, prohibits self-dealing, a comprehensively defined term. The Act also provides for a graduated series of sanctions against the self-dealer and against a foundation manager who willfully engages in self-dealing. In the case of willful repeated acts or a willful and flagrant act, the Internal Revenue Service can require the foundation either to pay back to the Government the income, estate, and gift tax benefits (with interest) which the foundation and all its substantial contributors have received or can require the foundation to distribute all its assets to a public charity or operate as a public charity itself. Appropriate opportunities for court review are provided. In addition each foundation's charter is required to prohibit the foundation from engaging in self-dealing.

The Act prohibits the following transactions between a private foundation and a disqualified person: (1) sale or exchange, or leasing, of property; (2) lending of money or other extension of credit; (3) furnishing of goods, services, or facilities; (4) payments of compensation or expenses by the foundation to a disqualified person; (5) transfer to or use by or for the benefit of a disqualified person, of the foundation's income or assets; and (6) payments to government officials. Payment by a private foundation of any of the taxes imposed by the new provisions upon any disqualified person falls within the scope of the fifth category and is prohibited.

A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, securities purchases or sales by the foundation in order to manipulate the prices of the securities to the advantage of the disqualified person constitute a "use by or for the benefit of, a disqualified person of the income or assets of a private foundation".

A "disqualified person" for purposes of this provision on self-dealing, as well as the provisions (discussed below) regarding excess business holdings and mandatory payouts, is (1) a substantial contributor, (2) a foundation manager, (3) a person who owns more than 20 percent of a corporation, partnership, trust, or unincorporated enterprise which is itself a substantial contributor, (4) a member of the family of any individual in the first three categories, or (5) a corporation, partnership, trust, or estate as to which all such persons (the first four categories) own in the aggregate more than 35 percent. In addi-

² The May 1969 issue of the American Bar Association Journal discussion of an instance of an attorney purchasing assets at fair market value from an estate he was representing suggests the problems even in "fair market value" self-dealing:

"The Ethics Committee said that it is generally 'improper for an attorney to purchase assets from an estate or an executor or personal representative, for whom he is acting as attorney. Any such dealings ordinarily raise an issue as to the attorney's individual interest as opposed to the interest of the estate or personal representative whom he is representing as attorney. While there may be situations in which after a full disclosure of all the facts and with the approval of the court, it might be proper for such purchases to be made * * * in virtually all circumstances of this kind, the lawyer should not subject himself to the temptation of using for his own advantage information which he may have personally or professionally * * *'"

tion, a "government official" (described below) is a disqualified person for purposes of the self-dealing provisions even if he is otherwise unrelated to the foundation.

A "substantial contributor" for these purposes is an individual, corporation, or other entity that has contributed in the aggregate more than 2 percent of the total contributions to the foundation up to that time. Even if this 2-percent test is met, however, the person is not a substantial contributor unless that person's contributions totaled more than \$5,000. Each contribution is taken into account at fair market value at the time it was made. If a husband and wife together contribute more than 2 percent, then each of them is a substantial contributor.

In the case of existing foundations, the calculations as to gifts made on or before October 9, 1969, are made as though all such gifts were contributed on that date. In the the case of gifts made after that date the calculations are made as of the close of each taxable year of the foundation. If a person was a substantial contributor as of October 9, 1969, or became one thereafter, he would remain a substantial contributor even though later contributions by others brought his total below the overall 2-percent de minimis level.

A "member of the family" of an individual includes only his spouse, ancestors, lineal descendants, and spouses of lineal descendants. The attribution rules applicable for these purposes are generally the same as those in the case of nonrecognition of losses in transactions between related parties.

The Congress was especially concerned that the rules as to who are substantial contributors and related persons be practicable and enforceable because the foundation needs to keep the records to identify those who are disqualified from dealing with it.

In view of the provisions to prohibit self-dealing, if a substantial donor owns an office building, the foundation should look elsewhere for its office space. (Interim rules provided in the case of existing arrangements are discussed below.)

A contribution of property is a self-dealing act if the foundation assumes a mortgage on the property or if the foundation takes the property subject to a mortgage placed by a disqualified person within 10 years before the transfer. A loan or the furnishing of goods, services, or facilities to the foundation is permitted if no interest or other charge is imposed and if the loan proceeds or the goods, services, or facilities are used exclusively for certain exempt purposes. The furnishing of goods, services, or facilities by the foundation is permitted if it is not on a basis more favorable than that available to the general public. The furnishing by a foundation of office space and similar facilities to its manager for use for the charitable purposes of the foundation (including necessary administrative activities) is not self-dealing, even if the general public does not normally have access to those offices. Payment by the foundation of compensation and expenses is permitted if the payment is not excessive and if the services are reasonable and necessary for the foundation's exempt purposes. Certain transactions regarding corporate stock are permitted if made on a uniform basis at fair market value.³

³ Transactions are permitted when entered into pursuant to liquidations, mergers, redemptions, recapitalizations, etc., if all securities of the same class as that held by the foundation are subject to the same terms and those terms provide for the foundation to receive not less than fair market value for its securities.

For purposes of the self-dealing provisions, government officials are disqualified persons. A government official is a person who, at the time of the self-dealing act, holds any of the following offices or positions: elective public office in the executive or legislative branch of the U.S. Government; a Presidentially appointed office in the executive or judicial branch of the U.S. Government; a position in any branch of the U.S. Government under civil service schedule C of rule VI or which is paid at least as much as the lowest "supergrade" (GS-16) salary (at present \$26,547 per year); a position under the U.S. House of Representatives or the Senate at a salary of at least \$15,000 per year; an elective or appointive public office in the executive, legislative, or judicial branch of a State or local government, a U.S. possession, or the District of Columbia, at a salary of at least \$15,000 per year; or a position as personal or executive assistant or secretary of any of the foregoing.

However, a government official who is a "special Government employee"—a temporary employee (less than 130 days a year), a part-time U.S. commissioner or magistrate, a part-time local representative of a Member of Congress in the Member's home district, or a Reserve or National Guard officer on active duty for training or involuntarily—is not a government official for these purposes.⁴

Compensation and reimbursement of expenses of government officials are prohibited (whether reasonable in amount or not) except that domestic travel expenses may be reimbursed within specified limits.⁵ On the other hand, the following items may be received by a government official: certain nontaxable prizes and awards if the recipients are selected from the general public,⁶ nontaxable scholarships and fellowship grants used for study at educational institutions, and annuity or other payments under certain stock-bonus, pension, and profit-sharing plans. A government official may also receive contributions or gifts (other than money) and services or facilities, if the aggregate value in any one year does not exceed \$25, and payments made under the Government employees training program authorized by chapter 41 of title 5, United States Code. These provisions are intended to minimize the possibility of improper influencing of the attitude or conduct of such policymaking level officials without interfering with legitimate activities.

If there has been a prohibited act of self-dealing, then a three-level set of sanctions is applied. The first level of sanctions consists of imposing a tax on the self-dealer at a 5-percent rate on the amount involved in the self-dealing for each year (or part thereof) from the

⁴ Military officers (other than those described above) who receive Presidential appointments are government officials regardless of the amount of their compensation.

⁵ The reimbursement is not to exceed the actual cost of the transportation plus 1¼ times the maximum U.S. per diem allowance under 5 U.S.C. 5702(a) for like travel. Public Law 91-114 increased this maximum per diem allowance from \$16 to \$25. As a result, the maximum reimbursement under this self-dealing provision now is \$31.25 per day plus actual transportation costs. See Rev. Rul. 65-212, 1965-2 C.B. 84, in which the Internal Revenue Service has exercised its authority under section 274(d) and Regs. § 1.274-5(f) to rule that a per diem allowance of no more than 1¼ times the Federal Government's per diem will generally satisfy the substantiation requirements under section 274 in the case of travel expense deductions under sections 162 or 212. Of course, the permitted reimbursement under this provision must not exceed actual expenses, even if actual expenses are less than \$31.25 per day.

⁶ The prize or award must be nontaxable under section 74(b). In order to meet that test, (1) it must be made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement; (2) the recipient must be selected without any action on his part to enter the contest or proceeding; and (3) the recipient is not required to render substantial future services as a condition to receiving the prize or award. In addition to meeting these tests of section 74(b), the recipient must be selected from the general public.

date of the self-dealing until the self-dealing is corrected (or the Internal Revenue Service mails a deficiency notice regarding the transaction, if sooner). The amount involved is the greater of the value of what the foundation gave or what it received at the time of the self-dealing. However, in the case of personal services by other than government officials, only the excess compensation is subject to the 5-percent tax. Where the self-dealing does not involve a transfer, then the amount involved is the amount used by or for the benefit of the self-dealer.

The first-level tax is imposed automatically, without regard to whether the violation was inadvertent. However, if the self-dealer is a disqualified person only because he is a government official then the tax on self-dealing is imposed only if he knowingly participated in the self-dealing.

Where this first-level tax is imposed, there is also a tax of 2½ percent on the foundation manager, but only if the manager knowingly participated in the self-dealing. The tax on the manager may not exceed \$10,000. Congress has concluded that, in order to avoid imposing unreasonable burdens upon foundation managers, it is appropriate (1) to apply this sanction to the manager only where the violation is willful and is not due to reasonable cause, and (2) to impose upon the Service the same burden of proof where such a sanction is being considered as is required in cases of civil fraud—that is, proof by clear and convincing evidence. Congress expects that the Commissioner of Internal Revenue will include in his annual report a review of the number of cases in which sanctions are imposed upon foundation managers.

The second level of sanctions applies if the self-dealing is not “undone” or (if undoing is not possible) the foundation is not made whole or given the benefit of the bargain within 90 days after the mailing of the deficiency notice with respect to the first level of tax. At the second level, the tax on the self-dealer is 200 percent of the amount involved. A second-level tax is also imposed on the foundation manager if he refuses to agree to any part of the correction. This tax is at the rate of 50 percent of the amount involved. Again, this tax on the manager may not exceed \$10,000. For purposes of this sanction, the amount involved is the highest fair market value of the property during the period within which the transaction may be undone. This provision is intended to impose all market fluctuation risks upon the self-dealer who refuses to comply and to give the foundation the benefit of the best bargain it could have made at any time during the period.

The second-level sanction, imposed only after a notice of deficiency and adequate opportunity for court review and undoing the self-dealing transaction, is intended to be sufficiently heavy to compel voluntary compliance (at least after court review). The Congress expects application of this sanction to be rare, but where the parties refuse to undo the transaction, it is expected that this sanction will be applied.

A penalty doubling the amount of the first or second level of tax is imposed in the case of repeated violations, or a willful and flagrant violation.

The 90-day period for the second level of tax provides an opportunity for court review and can also be extended if the Service determines that such extension is reasonable and necessary to correct the self-

dealing. For example, extensions will be granted if State officials take appropriate action to correct the self-dealing and preserve the assets for charity. Where the State officials take appropriate action which the Service determines to be sufficient to satisfy the requirements of this section, then the second-level tax is not to be imposed.

A third level of sanctions applies if there have been willful repeated acts or a flagrant and willful act to which the self-dealing rules apply. This sanction is discussed below in *Termination of Private Foundation Status*.

The first- and second-level taxes are treated like income, estate, and gift taxes in the sense that the Internal Revenue Service is required to send deficiency notices to the self-dealer and the foundation manager, who then have 90 days to petition the Tax Court. The usual statute of limitations for assessment applies—3 years unless there is a substantial omission of tax on the return filed by the foundation (6-year statute of limitations) or no return has been filed (assessment at any time).⁷ The 90-day period for petitioning the Tax Court and the statute of limitations for assessing and collecting the tax are suspended during any extension by the Service of the time for correcting the self-dealing.

The third-level tax is an income tax. As in the case of fraud, it may be assessed at any time.

Refund suits for first- or second-level taxes may be brought in the Court of Claims or in a district court (but only if there has been no prior court review of the prohibited act). Also, any refund suit is treated as disposing of all issues relating to any first- or second-level tax arising out of that prohibited act. An opportunity is provided for one court review of a self-dealing transaction, but no more than one review.

To limit opportunities for improper self-dealing, and to facilitate appropriate action by State officials to supervise private foundations, the Act requires, as a condition of tax exemption, that the foundation's governing instrument prohibit it from engaging in self-dealing. Existing organizations are given until 1972 to modify their governing instruments or longer if it is impossible to conform their governing instruments by then. However, to the extent that an existing organization is permitted to take certain action under the "savings provisions" (described in the immediately following paragraphs and at several other points in the PRIVATE FOUNDATIONS part of this explanation), then that organization's governing instrument is not required to forbid that action.

Effective date.—The self-dealing provisions took effect on January 1, 1970; however, they do not apply to (1) transactions pursuant to the terms of certain securities (such as callable preferred stock) acquired by the foundation before May 27, 1969, (2) dispositions, at fair market value or better, of excess business holdings held by the foundation on May 26, 1969,⁸ and (3) use of property in which the foundation

⁷ Congress understands that the exempt organization information return will be revised to have one or more questions on it regarding the first- and second-level taxes, sufficient so it will constitute an excise tax return. This procedure is followed because the first- and second-level taxes are excise taxes, under subtitle D, and the statute of limitations provisions regarding such taxes depend upon the filing of a return of subtitle D taxes.

⁸ Such a sale is not disqualified by being made in such a way that both the selling foundation and the purchasing disqualified person avoid the payment of brokerage commissions. Also, in the case of dispositions before January 1, 1975, for the purposes of this exception to the self-dealing rules a foundation's maximum permitted business holdings shall be the general limit of 20 or 35 percent and not the special higher limits that may apply in the case of existing holdings, as described below in *Taxes on Excess Business Holdings*.

and a disqualified person have joint interests, but only if both parties acquired their interests before October 9, 1969.

In addition, the Act makes provision for certain transitional rules designed to permit the continuance of leases, loans, extensions of credit, and sharing arrangements which were in effect on October 9, 1969. These may continue for not more than 10 years, but only where they are not disadvantageous to the foundation and continue to avoid disadvantage to the foundation at all times during the 10-year period.

If the parties choose to modify an existing arrangement as to matters that are not substantial, such modifications are permitted only if the modified arrangement is at least as advantageous to the foundation as the arrangement had been immediately before the modification. In addition, property acquired in the future under a will executed by May 26, 1969,⁹ or under the mandatory provisions of a trust or document transferring property to a trust if such provisions were irrevocable on May 26, 1969, and at all times thereafter until the foundation's acquisition, is treated as though such property had been acquired by the foundation before May 27, 1969, for purposes of the special rule permitting fair market value dispositions of existing excess business holdings.

These provisions have been included in the Act in order to permit the orderly elimination of existing arrangements. Congress does not wish to permit such arrangements or sales for the future, but believes limited exceptions are desirable so that an appropriate transition can be made.

3. Taxes on Failure to Distribute Income (sec. 101(b) of the Act and sec. 4942 of the code)

Prior law.—Prior law (sec. 504(a)(1) of the code) provided that a private foundation lost its exemption if its aggregate accumulated income was “unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3).”

General reasons for change.—Under prior law, if a private foundation invested in assets that produced no current income, then it needed to make no distributions for charitable purposes. As a result, while the donor may have received substantial tax benefits from his contribution currently, charity may have received absolutely no current benefit. In other cases, even though income was produced by the assets contributed to charitable organizations, no current distribution was required until the accumulations became “unreasonable.” Although a number of court cases had begun to set guidelines as to the circumstances under which an accumulation became unreasonable, in many cases the determination was essentially subjective. Moreover, as was the case with self-dealing, it frequently happened that the only available sanction (loss of exempt status) either was largely ineffective or else was unduly harsh.

Explanation of provisions.—The Act provides that private foundations must distribute all income currently (but not less than 6 percent of investment assets), and imposes graduated sanctions in the event

⁹ If a later codicil to such a will changes the rights of the foundation, the codicil causes the will to be treated as having been executed on the date of the codicil.

of failure to distribute.¹⁰ Provision is made to extend the time within which the distributions must be made in certain circumstances and to allow a carryforward of "excess" distributions.

The current distribution requirement applies to all of the net income of the private foundation (including the excess of exempt interest over the expenses of earning the interest), other than net long-term capital gains. Expenses of earning the income, including depreciation and depletion where appropriate, are deductible in computing the net income subject to this rule.¹¹ However, depreciation is limited to straight line and depletion to cost, in the same manner as in the determination of net investment income for purposes of the 4-percent tax described above in the section entitled *Excise Tax on Investment Income*.

To prevent avoidance of the requirement for distribution of income by investments in growth stock or nonproductive land, the Act requires a foundation to pay out at least a specified percentage of its average noncharitable assets. The minimum payout is set at 6 percent for taxable years beginning in 1970 in the case of new organizations (this rule is modified for existing organizations, as described below). The Secretary of the Treasury is authorized to adjust this rate prospectively from time to time based on changes in money rates and investment yields using as the standard the 6-percent rate, given rates and yields for 1969. This does not mean that a foundation may not make low-yield investments if it so desires. However, if it does so it is likely that the foundation will find either that it periodically must sell shares to enable it to meet the payout requirements or that it must distribute shares to public charities in partial satisfaction of those requirements.

Under the Act, it is clear that the excise tax on investment income (described above) and the unrelated business income tax reduce the amount the foundation must pay out to meet the minimum distribution requirements, and that reasonable administrative expenses of operating the foundation constitute qualifying distributions.

Assets used directly for the active conduct of the foundation's exempt purposes are not included in the base upon which the 6-percent payout applies. The value of assets which can be easily ascertained is to be determined by averaging the monthly values of the assets. Other assets will be valued as frequently as is appropriate. Foundations are permitted to make deficiency distributions (along the lines of the deficiency dividend procedure at present followed by personal holding companies) to the extent that failure to distribute the proper amount results from a failure to properly value the foundation's assets, if the failure was not willful and was due to reasonable cause.

Under the Act, payouts must be made in the year in which the money is received or in the next year, except to the extent that the foundation is permitted to set aside funds for periods of up to 5 years for certain major projects (as described below). Any such set-asides must be approved in advance by the Internal Revenue Service. The Service may extend the 5-year period if good cause is shown. This exception is intended to apply to those situations where relatively

¹⁰ The Act also repeals sec. 594 since with the change referred to above it is no longer needed.

¹¹ Operating foundations (described below in *Private Operating Foundation Definition*) are subject to different requirements regarding expenditures and the use of their assets; they are not required to meet the distribution requirements provided in this section. As indicated below, they normally are proper recipients of distributions which qualify under this section.

long term grants must be made in order to assure continuity of particular charitable projects or where the grants are made as part of a matching grant program. This exception does not apply unless it is established that the amount set aside will in fact be paid out for the specific project within 5 years. It is expected that such set-asides will be approved where the State attorney general undertakes appropriate action to insure that the funds will be timely and charitably distributed.¹²

A further exception is provided where a private foundation distributes more than the minimum required payout in a given year. Such excess distributions may be applied against required payouts in the next 5 years. The amounts of distributions in years beginning before December 31, 1969, are not to be taken into account for purposes of applying this 5-year carryover rule.

For the purpose of this payout requirement, qualifying distributions include distributions to "public charities" and private operating foundations, direct expenditures for charitable purposes, and expenditures for assets to be used for charitable purposes. Contributions to other private foundations are not forbidden, but (except in the case of a contribution to a private operating foundation or a "one-year pass-through," described below) they do not count as qualifying distributions for the minimum payout. It is expected that the Internal Revenue Service will publish lists of operating foundations that may be used by foundation managers desiring to make qualifying distributions.

Where a student loan or any other capital expenditure, which previously had been a qualifying distribution, is later repaid or liquidated, the repayment (sale, or other liquidation) is to be considered to be income in the year of the repayment (or other transaction) to the extent of the prior qualifying distribution. This is to prevent such loans and purchases from being used to evade the minimum payout rules, without interfering with their use for proper charitable purposes.

The Act provides that a foundation may not make a qualifying distribution to a controlled organization. (This is modified to some extent by the one-year pass-through provision described below.) An organization is "controlled" by a granting foundation and disqualified persons if all such persons may, by aggregating their votes or positions of authority, require the donee organization to make a distribution, or prevent the donee organization from making a distribution. For this purpose the organization controlled by a private foundation need not be another private foundation; it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

However, a distribution to another private foundation or to a controlled 501(c)(3) organization is a qualifying distribution if (1) the funds are spent or used for charitable purposes by the end of the taxable year after the year of receipt by the donee organization, and (2) the donee organization spends or uses the funds, in addition to making sufficient other distributions to meet its regular minimum pay-

¹² The rule described more fully below, to include in income for this purpose any receipt on the liquidation of a student loan or sale of a charitable asset, is also to apply to the set-asides described here. That is, where an amount is set aside and as a result is treated as a qualifying distribution, if it is later determined that the amount is not needed for the purpose for which it was set aside, then the amount remaining is taken back into income.

out requirements. This permits an additional year's delay in the payment of funds into the stream of charitable expenditures but provides flexibility in operations for private foundations. To limit any further delay, however, the donee organization is not permitted to pass such a grant through to another private nonoperating foundation or to a controlled organization.

These distribution requirements do not apply to a private operating foundation except that the one-year pass-through rule applies in the case of a controlled operating foundation. As indicated above, a private operating foundation is a qualified recipient of distributions. The requirements that an organization must meet in order to qualify as a private operating foundation are discussed below.

Failure to comply with the minimum payout requirements results in sanctions against the foundation. The first level of sanction is a tax of 15 percent of the amount that should have been, but was not, paid out. This tax is imposed for each year until the private foundation is notified of its obligation or until the foundation itself corrects its earlier failure by making the necessary payouts. However, as indicated above, to the extent the failure to meet the minimum payout requirement results from an incorrect valuation of the foundation's relevant assets and this incorrect valuation is not willful but is due to reasonable cause, then the foundation can avoid the first-level tax by promptly making additional distributions (following the lines of the deficiency dividend procedure already available to personal holding companies).

As is the case with self-dealing, within 90 days after notification by the Internal Revenue Service the foundation must correct its failure to make the appropriate charitable distributions. This 90-day period may be extended as described above under *Prohibitions Against Self-Dealing*. If the necessary distributions are not made within the appropriate period, the second level of sanctions is imposed—a tax of 100 percent of the amount required to be paid out.

Provisions regarding penalties for repeated or flagrant violations, court review, the third level of sanctions, and the governing instrument are the same as those described under *Prohibitions Against Self-Dealing*.

Effective date.—The payout requirements apply to taxable years beginning after December 31, 1969. However, in the case of an existing organization, the minimum payout (the 6-percent rule described above) does not apply until taxable years beginning after December 31, 1971 and for a temporary period is modified as set forth below.

To afford existing organizations a greater opportunity to revise their investment and payout practices, a phase-in period was added with regard to the 6-percent rule. The minimum payout will be 4½ percent for taxable years beginning in 1972, 5 percent in 1973, 5½ percent in 1974, and 6 percent in 1975 and later years. If the 6-percent figure is decreased by the Secretary of the Treasury before 1975, then the phase-in period percentages are to be proportionately adjusted.

The minimum payout amount does not apply to the extent it cannot be met because the foundation's governing instrument, existing before May 27, 1969, requires income to be accumulated. However, this exception to the minimum payout rule applies only if the accumulation requirement in the governing instrument would not have caused the organization to lose its exempt status under prior law. Also, the

minimum payout requirement does not apply to the extent that the foundation's existing governing instrument forbids invasion of corpus to meet the payout requirement. These exemptions will continue after 1971 only to the extent that it is impossible to reform the foundation's governing instrument to permit it to comply with the general rule. The exemption relating to invasion of corpus is further restricted—it applies after 1971 only during the necessary pendency of a suit instituted before that time to reform the instrument or to excuse the foundation from compliance with the instrument's limitation. After that time, the foundation will be required to meet the minimum payout requirement (and be subject to sanctions upon failure to do so) even if the governing instrument continues to prohibit invasion of corpus.

The Congress also recognized that existing obligations may have been undertaken in good faith by foundations in the past. In order to permit such obligations to be carried out, the Act provides that a grant within the next 5 years to a noncontrolled private foundation (even if it is not an operating foundation) under a written commitment which was binding on May 26, 1969, and at all times thereafter, is treated as a grant to an operating foundation, if the grant is made in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption. Moreover, the expenditure responsibility requirements (described below in *Taxes on Certain Expenditures of Foundations*) do not apply to such a grant. The donee private foundation, however, is subject to all the limitations imposed by the Act upon private foundations.

4. Taxes on Excess Business Holdings (sec. 101(b) of the Act and sec. 4943 of the code)

Prior law.—Prior law did not deal directly with foundation ownership of business interests, although some cases had held that business involvement could become so great as to result in loss of exempt status.

General reasons for change.—The use of foundations to maintain control of businesses appeared to be increasing. It was not clear under prior law at what point such noncharitable purposes became sufficiently great to disqualify the foundation from exempt status. Moreover, the loss of exempt status is a harsh sanction for having such holdings.

The Treasury Department in its 1965 study of private foundations included the following examples of where business, and not charitable, purposes appeared to predominate in foundation activities:

Example 1.—The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately \$10,500,000 at the end of 1962 and with gross receipts of more than \$17 million for that year. Another of the corporations operates the largest radio broadcasting station in the State. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than \$20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in one city, these

properties present an economic empire of substantial power and influence.

Example 2.—The B foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

Example 3.—The C foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

During the consideration of the Tax Reform Act of 1969, a major newspaper carried the following advertisement:

"Tax exempt organization will purchase companies earning \$300,000 pre tax at high earnings multiple. Immediate action."

Those who wished to use a foundation's stock holdings to acquire or retain business control in some cases were relatively unconcerned about producing income to be used by the foundation for charitable purposes. In fact, they might have become so interested in making a success of the business, or in meeting competition, that most of their attention and interest was devoted to this with the result that what was supposed to be their function, that of carrying on charitable, educational, etc., activities was neglected. Even when such a foundation attains a degree of independence from its major donor, there is a temptation for its managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable ownership predominates, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses. To deal with these problems, Congress concluded it is desirable to limit the extent to which a business may be controlled by a private foundation.

Explanation of provisions.—The Act limits to 20 percent the combined ownership of a corporation's voting stock which may be held in the future by a foundation and all disqualified persons together. If it can be demonstrated that some unrelated party has effective control over the business, the 20-percent limit is raised to 35 percent.

If the applicable percentage limit for stock holdings is exceeded, then the foundation must reduce its holdings to the extent necessary to bring the combined holdings down to this limit.¹³ Also, where there are excess holdings, the foundation must dispose of its nonvoting stock as well as its voting stock.

Excess holdings acquired by gift or bequest in the future generally must be disposed of within 5 years in order to avoid sanctions. However, the sanctions begin to operate immediately in the case of an excess holding resulting from a purchase by the foundation or by a disqualified person. Exceptions are provided in the case of related

¹³ A *de minimis* rule permits the foundation to retain not more than 2 percent of the voting stock, notwithstanding this limitation, but the holdings of related private foundations are aggregated for the purpose of this exception. This is done to avoid the use of "multiple foundations" to convert the *de minimis* rule into a method of evading the basic rule of this provision.

businesses, special rules apply to preexisting holdings, and there are a series of graduated sanctions to induce compliance.

The Act uses only voting stock in this case to determine whether divestiture should be required, because it does not appear probable that a foundation's holding of nonvoting stock could be effectively used to preserve control if the disqualified persons hold little or no voting stock. On the other hand, if the disqualified persons, or such persons and the foundation combined, hold more than 20 percent of the voting stock, then the foundation's holding of nonvoting stock might effectively remove from outsiders any practical opportunity to gain control. Under those circumstances the foundation's retention of even the nonvoting stock might well be the result of decisions to place the interest of disqualified persons ahead of charitable interests.¹⁴

The above rules have been stated in terms of corporate stock but corresponding limitations apply to partnerships and other entities. A private foundation is not permitted to own a business as a sole proprietorship.

In computing the amount of stock considered as held by the foundation and related parties, stock held by corporations, partnerships, estates, and trusts is deemed to be held proportionately by the shareholders, partners, and beneficiaries of those entities. However, where the foundation holds only an income interest or only a remainder interest in a "split-interest" trust, then that interest will not be attributed to the foundation. To provide otherwise (i.e., to require attribution without limit) in some cases would result in the foundation being required to divest itself of stock it does not hold.

The Congress concluded that the divestiture rules applicable to nonexempt trusts with charitable interests,¹⁵ and attribution to holders of other interests in the trust are sufficient so that the use of trusts will not significantly delay divestitures. In any event, the foundation is treated as having acquired the stock in a trust when its remainder interest becomes a current possessory interest.

The Act also provides that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of the underlying assets of the holding company. The Congress also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding. Where a corporation purchases a product under a contract with the manufacturer, resells it under contracts at a uniform markup in price, and does not physically handle the product, the income derived from that markup is in the nature of a royalty and meets the definition of passive income. On the other hand, income from individually negotiated sales such as those made by a broker, would not meet the passive income definition, even if the broker did not physically handle the goods.

Business holdings do not include "program-related investments" (such as investments in small businesses in central cities or in corporations to assist in neighborhood renovation) which are part of the

¹⁴ Compare the different rules described below regarding existing business holdings, where 50-percent combined ownership is permitted.

¹⁵ The nonexempt "split-interest" trusts are subject to the divestiture requirements when the interests of charity in the trust amount to more than 60 percent.

foundation's charitable program, where the making of a profit for the foundation is not one of the significant purposes for holding these investments.

An exception to the limitations on the holding of business interests is provided in the case of a business which is related under the provisions dealing with taxes on unrelated business income. Another exception is provided, even where the business, although unrelated to the direct activities of the foundation, "is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization."

These exceptions are intended to make clear that certain types of business activities may continue to be held by the foundation notwithstanding the general rule. For example, the Inn and Lodge at Colonial Williamsburg are separately incorporated taxable entities, but are owned by the foundation for the convenience of the general public visiting Williamsburg. Also, many museums maintain cafeterias and snack bars for the convenience of the public visiting the museums. Although advertising in a foundation's journal may be an unrelated trade or business it comes under the second of these exceptions if the foundation's journal is related to the foundation's exempt purposes. Such business activities do not have to be disposed of under these provisions. If a private foundation were exempt under the prior statutory provisions as a charitable scientific organization, then its tax-paying subsidiaries may continue to be wholly owned if they serve to translate the scientific achievements of the foundation into human progress by such means as demonstrating the feasibility of new scientific discoveries, or aiding in the economic or technical development of geographical areas by bringing to the public innovative products and processes which might not otherwise reach the public.

The rules described above—requiring divestiture where the combined business holdings of the foundation and all disqualified persons together exceed 20 percent (or 35 percent in some cases)—do not apply to existing holdings. Where existing holdings are in excess of 50 percent but are not in excess of 75 percent, a 10-year period is available before the holdings must be reduced to 50 percent. If the holdings are more than 75 percent the reduction to 50 percent need not occur for a 15-year period. However, the 15-year period is expanded to 20 years if the foundation itself holds more than 95 percent of a corporation's stock. On the other hand, the 15-year period is reduced to 10 years if substantial contributors or members of their families having 15 percent or more of the stock of the corporation object to the additional 5 years for disposition of the excess holdings.

If at the end of the 10, 15, or 20-year period referred to above, the already existing foundation and all disqualified persons together have holdings not in excess of 50 percent and the foundation has holdings of not more than 25 percent, then no further divestiture is required in order to avoid application of the taxes on excess holdings. If the disqualified persons together hold no more than 2 percent of the stock, the foundation is not subject to the 25-percent limit of the preceding sentence (however, the 50-percent total still applies to the combined holdings at the end of this first period); instead the foundation, in this

case, has 15 additional years to bring the combined holdings of the stock in question down to 35 percent without imposition of any tax under this provision.¹⁶

The percentages, in the case of the special rules applicable to existing holdings, are determined both on the basis of the voting power of the stock outstanding and (separately) on the basis of the value of the stock outstanding.¹⁷ However, the conversion features of convertible bonds and other securities are ignored for the voting test until the conversion occurs. The conversion features are, of course, considered in determining the value of the outstanding stock.

In general, "existing holdings" refers to holdings on May 26, 1969. However, the rules as to existing holdings also apply in the case of stock acquired after that date if it is acquired pursuant to the terms of a trust which was irrevocable on the date or pursuant to the terms of a will executed before that date.¹⁸

The time available for divestiture of excess business holdings obtained from a trust or estate begins to run from the time the foundation actually receives the stock from the trust or estate. The Service has been upheld, in situations where final distributions of estates and trusts were being unduly delayed, in treating the estates and trusts as having actually distributed all their assets when the distributions would have been made but for the undue delay.

If existing holdings are below the 50-percent limitation but above the 20-percent (or 35-percent) limitation applicable for the future, then the percentages of stock held on May 26, 1969, become the applicable limitations for the foundation and all disqualified persons until May 26, 1979. If an existing foundation reduces its present percentage holdings of a corporation, it may not again increase these holdings except that if they fall below the levels applicable for future holdings (namely, the 20 percent or 35 percent levels) they may be increased to these levels.

A de minimis provision allows for fluctuations on account of issuances or redemptions of small amounts of stock, which would otherwise require continual readjustments in the case of publicly held corporations.

Limited exceptions to the self-dealing rules in the case of current excess business holdings were discussed above in *Prohibitions Against Self-Dealing*. Section 906 of this Act (reasonable accumulations by corporations) also provides that redemptions of stock by a closely held corporation from a foundation will not result in imposition of the accumulated earnings tax with respect to that corporation if the stock is redeemed in order to comply with the divestiture requirements. Also, a redemption for such purposes will not give rise to dividend treatment to the foundation (for purposes of the income distribution requirement and the excise tax on investment income) or to other shareholders of the corporation. Where an exchange is permitted as an

¹⁶ The divestiture periods in the case of existing holdings (the 10, 15, or 20-year periods described above) run from May 26, 1969, except in the case of existing trusts and wills, as described below. If a future acquisition by a disqualified person or by the foundation results in a requirement of divestiture by the foundation, then the time allowed for divestiture begins to run from the date the total holdings exceed the permitted percentages.

¹⁷ Nonvoting stock may be of little significance in determining control when the voting percentage is limited to 20 percent, but is almost certain to be of significance, even in closely held companies, when the limit on voting stock is raised to 50 percent.

¹⁸ If stock would pass to the foundation under a will that meets the test referred to above but before that time actually passes under a trust which would have met that test but for the fact that the trust was revocable (even though it was not in fact revoked), then the stock is for the business holding requirement treated as having been acquired by the foundation under the will.

exception to the self-dealing rules, then the property received in such an exchange after May 26, 1969, is not treated as having been purchased. (As indicated above the 5 years available for divestitures of future-acquired property is not available for purchases.) For example, if a substantial donor to a foundation leaves a number of business holdings jointly to his widow and his foundation, the widow and the foundation then exchange their half-interests so that each owns 100 percent of half the businesses, and this exchange does not violate the self-dealing rules because it conforms to the special exception to those rules provided by the Act in the case of existing holdings, then the business holdings are not treated as having been acquired by the foundation by purchase. These provisions, too, are available only in the case of May 26, 1969, excess holdings (including those excess holdings under existing wills and existing irrevocable trusts.)

Congress concluded that the less stringent divestiture rules described above were desirable in existing situations in order not to disrupt a foundation's investment plans and also because to do otherwise would materially affect the worth of the business being divested. However, the Congress believed that as to the future, where the excess holdings develop after knowledge of the new rules, five years are sufficient for divestiture.

A series of sanctions applies to the foundation if it does not meet the divestiture requirements. The first-level sanction is a tax of 5 percent each year on the value of the greatest amount of excess holdings at any time during the year.

The foundation will ordinarily have had at least 5 years (10, 15, or 20 in the case of existing holdings) to dispose of its excess business interests before this sanction applies.

After the imposition of the 5-percent tax the same 90-day correction period (with possible extensions) is available here as in the case of self-dealing. If the excess holdings are not disposed of during the correction period, then a second-level sanction—a tax of 200 percent of the value of the excess holdings—is imposed upon the foundation.

Provisions regarding penalties for repeated or flagrant violations, court review, the third level of sanctions, and reformation of the governing instrument are the same as in the case of self-dealing.

Effective date.—The limitations on business ownership apply to taxable years beginning after December 31, 1969. An exception is made for existing holdings which are required by the governing instrument to be retained, but only during the necessary pendency of a suit instituted to reform the instrument or to excuse the foundation from compliance with the instrument's limitation.

The Act provides an exception permitting retention of 51 percent of a business' stock in the case of foundations incorporated before January 1, 1951, where substantially all of the assets of the foundation on May 26, 1969, consisted of more than 90 percent of the stock of an incorporated business enterprise which is licensed and regulated, the sales and contracts of which are regulated, and the professional representatives of which are licensed, by State regulatory agencies in at least 10 States and the foundation received its stock solely by gift, devise, or bequest. Stock of a company placed in trust before May 27, 1969, with provision for the charitable remainder to go to the foundation upon the death of the life beneficiary also is treated as coming under this provision if the foundation held on May 26, 1969, without regard to this trust, more than 20 percent of the stock of the enterprise.

Such a foundation also must not purchase any stock in that business enterprise after May 26, 1969, must not acquire in the future any stock in another business enterprise which would represent excess business holdings and must have expended between 1965 and 1970, substantially all of its income for its tax-exempt purposes.

5. Taxes on Investments Which Jeopardize Charitable Purpose (sec. 101(b) of the Act and sec. 4944 of the code)

Prior law.—Prior law (sec. 504(a)(3)) provided that a private foundation was to lose its exemption if its accumulated income was invested in such a manner as to jeopardize the carrying out of its exempt purposes (under sec. 501(c)(3)). No similar specific limitations applied to investment of principal.

General reasons for change.—The grant of current tax benefits to donors and exempt organizations usually is justified on the basis that charity will benefit from the gifts. However, if the organization's assets are used in a way which jeopardizes their use for the organization's exempt purpose this result is not obtained. Prior law recognized this concept in the case of income, but not in the case of an organization's principal.

Under prior law a private foundation manager might invest the assets (other than accumulated income) in warrants, commodity futures, and options, or might purchase on margin or otherwise risk the corpus of the foundation without being subject to sanction. (However, in one case a court held that the consistent practice of making such investments constituted operation of the foundation for a substantial non-exempt purpose and would result in loss of tax exemption.)

The Congress determined that investments which jeopardize the foundation's corpus should not be permitted. Here, as in other sections, the Congress concluded that, to achieve this objective, limited sanctions were preferable to the loss of exemption.

Explanation of provisions.—The Act imposes upon all assets of a foundation the same limitations previously applicable to accumulated income. As a result, under this provision, a foundation cannot invest its corpus in a manner which would jeopardize the carrying out of its exempt purposes.¹⁹

However, the Act makes it clear that a program-related investment—such as low-interest or interest-free loans to needy students, high risk investments in low-income housing, and loans to small businesses where commercial sources of funds are unavailable—is not to be considered as an investment which might jeopardize the foundation's carrying out of its exempt purposes (since such an investment is classified as a charitable expenditure). To qualify as program related, the investment must be primarily for charitable purposes and not have as one of its significant purposes that of deriving a profit for the foundation.

The determination of whether investments jeopardize the carrying out of the foundation's charitable purposes is made as of the time of the investment, in accordance with a "prudent trustee" approach, and not subsequently, on the basis of hindsight after a loss occurs.

Where investments are made in a manner which jeopardizes the carrying out of the organization's exempt function, there is an initial sanction on private foundations of 5 percent of the amount involved.

¹⁹ These provisions replace section 504 of prior law, the violation of which resulted in loss of tax exemption.

A foundation manager who knowingly jeopardizes the carrying out of the foundation's exempt purposes is also subject to an initial tax of 5 percent (up to a maximum of \$5,000). Where the jeopardy situation is not corrected, there is a second level sanction or tax of 25 percent on the foundation and a 5-percent tax on the foundation manager who refuses to take action to correct the situation (in the case of the foundation manager, this sanction may not exceed \$10,000).

Before the second-stage sanctions are imposed, the State Attorney General is given an opportunity to intervene in the case to exercise whatever powers he has to correct the situation. Where the Treasury Department finds the situation is corrected, the second-level sanctions are not imposed.

Provisions regarding penalties for repeated or flagrant violations, third-level sanctions, court review, governing instrument provisions, and the procedures followed in imposing sanctions upon foundation managers are essentially the same as those which apply in the case of self-dealing.

Effective date.—This provision took effect on January 1, 1970.

6. Taxes on Certain Expenditures of Foundations (sec. 101(b) of the Act and sec. 4945 of the code)

Prior law.—Prior law (sec. 501(c)(3), unchanged by the Act) requires that no substantial part of the activities of a private foundation may consist of carrying on propaganda or otherwise attempting to influence legislation. It further provides that no such organization may "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."²⁰

Although these provisions permit some degree of influencing legislation by the organization involved, they permit no degree of support for an individual's candidacy for public office.

Prior law (sec. 504(a)(2)) also provided that a private foundation lost its exemption if its accumulated income was used to a substantial degree for purposes other than its exempt purposes.

General reasons for change.—As is the case with the other limitations described above (self-dealing, accumulation of income, etc.), the only sanction available under prior law with respect to political activity by a foundation was loss of exemption and denial of charitable contribution deduction status; a large organization, merely because of the substantiality test, might engage without consequence in more lobbying than a small organization; a heavily endowed organization might engage in lobbying and, if it lost its exempt educational or charitable status, might avoid tax on its investment income by becoming exempt under another provision of the law; also, the standards as to the permissible level of activities under prior law were so vague as to encourage subjective application of the sanction.

Another problem arose from the fact that the absolute prohibition upon involvement in political campaigns on behalf of any candidate for public office frequently resulted in the alternatives of unreasonably severe punishment or unreasonably light punishment. As a practical matter, many organizations often found ways of making clear their

²⁰ The corresponding charitable contributions deduction provision (sec. 170(c)(2)(D)), which prohibited substantial propaganda activities but did not deal specifically with the electioneering activities, is amended by sec. 201(a) of the Act to include the electioneering prohibition.

views regarding opposing political candidates without fear that their exempt status would be revoked. Also, there was no prohibition against taking sides as to referendum issues. The latter activity was regarded as influencing legislation, but, as indicated above, that was specifically permitted to a limited extent.

In recent years, private foundations had become increasingly active in political and legislative activities. In several instances called to the Congress' attention, funds were spent in ways clearly designed to favor certain candidates. In some cases, this was done by financing registration campaigns in limited geographical areas. In other cases contributions were made to organizations that then used the money to publicize the views, personalities, and activities of certain candidates. It also appeared that officials of some foundations exercised little or no control over the organizations receiving the funds from the foundation.

Congressional policy regarding carrying on this type of political activity with tax-exempt or tax-deductible funds appears to be clear in view of the statutory language set forth above, the nondeductibility of contributions to political parties, and the provisions which forbid the use of bad debts, advertising expenses, and other devices to secure deductions for what are, as a practical matter, political contributions (secs. 162(e), 271, and 276).

It also was called to the Congress' attention that prior law did not effectively limit the extent to which foundations could use their money for "educational" grants to enable people to take vacations abroad, to have paid interludes between jobs, and to subsidize the preparation of materials furthering specific political viewpoints.

The Congress concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. Accordingly, the Congress determined that a tax should be imposed upon expenditures by private foundations for activities that should not be carried on by exempt organizations (such as lobbying, electioneering, and "grass roots" campaigning). The Congress also believes that granting foundations should take substantial responsibility for the proper use of the funds they give away.

In general, the Congress' decisions reflect the concept that private foundations are stewards of public trusts and their assets are no longer in the same status as the assets of individuals who may dispose of their own money in any lawful way they see fit.

Explanation of provisions.—The Act forbids private foundations to spend money for lobbying, electioneering (unless certain standards are met, this includes voter registration drives), grants to individuals (unless there are assurances that the grants are made on an objective basis), grants to other organizations (other than public charities) unless the granting foundation accepts certain responsibilities as to the use of the funds by the donee organization, and for any purpose other than the exempt purposes of private foundations. Any improper expenditure is subject to tax.

One of the provisions of the Act specifically prohibits the incurring of expenses in connection with "grass roots" campaigns or other attempts to influence any legislation through an attempt to affect the opinion of the general public or any segment thereof. This prohibition

is substantially similar to the existing provision (sec. 162(e), unchanged by this Act), which prohibits business deductions for grass roots lobbying activities. Another provision in the Act precludes direct attempts to persuade members of legislative bodies or government employees to take particular positions on specific legislative issues, except in the course of technical advice or assistance rendered in response to a written request. The request must come from a body such as a legislative committee, and not merely from a single official. The response must be made only to the body that requested the technical advice or assistance.

Essentially, this provision removes the "substantiality" test in determining whether a private foundation has made a taxable expenditure in this area.²¹ It should be made clear, however, that this provision (sec. 4945(e)) does not prevent the examination of broad social, economic, and similar problems of the type the government could be expected to deal with ultimately, even though this does not permit lobbying on matters which have been proposed for legislative action. Under the Act, it is clear that the expertise of a private foundation is not denied to lawmakers when the lawmakers or other appropriate persons have made written requests for such technical advice or assistance.

The prohibition on propaganda or other attempts to influence legislation does permit making available the results of nonpartisan analysis, study, or research. The grass roots provision is not to be treated as having been violated merely because a matter that was the subject of such a study might be expected to be dealt with ultimately by government. Current problems to which this rule would apply include environmental pollution and population growth. Also, a private foundation may appear before, or communicate with, any legislative body regarding possible decisions which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to the foundation. However, this latter exception does not extend to grass roots campaigns on such subjects.

A noncommercial educational broadcasting (TV or radio) station's adherence to Federal Communications Commission regulations and the "fairness doctrine" (requiring balanced, fair, and objective presentations of issues, and forbidding editorializing) means that such station has not violated the lobbying provision.²²

The "balance" requirement could be achieved under the Act (as under broadcasting law) in a series of broadcasts even though any single broadcast might not present a completely balanced view of an issue. A private foundation could make grants, or use its money, for such purposes, provided that each grant or a series met these tests.

The prohibition on electioneering is expanded by the Act to apply to efforts to influence the outcome of referenda as well as campaigns by individuals for public office. The electioneering provisions are limited to expenditures for the purpose of influencing the outcome of any *specific* election because of concern that otherwise it might be argued that almost any statement, study, or general educational activity could at a future date become an issue in an election, depending upon the

²¹ The substantiality test remains when the question is as to retention of exempt status.

²² It appears that many such stations are publicly supported, through community chest drives or otherwise, and many others are agencies of local governments. However, some may be private foundations. It is thought that most if not all of those that are private foundations qualify as operating foundations.

views of the candidates at that time. As so limited, this provision prohibits the preparation of any materials that are designed to favor or hinder any particular candidate for public office or any particular viewpoint in the case of a referendum.

Voter registration drive expenditures are prohibited unless: (1) the organization carrying on the drive is exempt under section 501(c)(3) of the code (the organization may itself be a private foundation); (2) the organization's activities are nonpartisan, are carried on in five or more States, and are not confined to one election period; (3) substantially all of the organization's income must be expended directly for the active conduct of its activities; (4) substantially all of its support (other than investment income) in any five-consecutive-year period must be received from exempt organizations, governments, or the general public, with no more than 25 percent of that noninvestment support from any one exempt organization and no more than 50 percent of its total support from investment income; and (5) voter registration drive contributions may not be subject to the condition that they may be used only in specific States or areas or in only one specific election period.

The Act imposes sanctions upon the making of grants to individuals by private foundations unless the grantees are chosen in open competition or on some other objective and nondiscriminatory basis, in accordance with procedures approved in advance by the Internal Revenue Service. This approval procedure does not contemplate specific approval of particular grant programs but instead one-time approval of a system of standards, procedures, and follow-up designed to achieve the intended degree of objectivity. Where the grants take the form of scholarships there will normally be available the relatively independent supervision of schools and colleges. Prizes or awards that qualify under existing law (sec. 74(b)) for exclusion from income also may be made if the recipient is selected from the general public. Except where the procedures or standards set forth above are followed, the Act requires that any grant by a private foundation be directed toward the production of a specific product (a book, paper, or other study, or a scientific development or useful process), the achievement of a specific objective, or the improvement or enhancement of a literary, artistic, musical, scientific, teaching, or other similar capacity, talent, or skill. The scholarships, prizes, and other individual grants that a private foundation may make must meet the standards described at the beginning of this paragraph.²³ It is expected that procedures will be promulgated in the near future in accordance with recommendations by a committee that the Commissioner of Internal Revenue appointed in 1969 for this purpose.

A grant, but not a contract for services, is limited by this provision.

The Act forbids a private foundation to make grants to organizations other than "public charities" unless the granting foundation assumes "expenditure responsibility." Under this requirement, the granting foundation must make reasonable efforts and establish adequate procedures to see that the funds are spent for the purposes of the grant, obtain full and complete reports as to how the funds are spent, and make full and detailed reports to the Internal Revenue Service regarding such expenditures. This expenditure responsibility is

²³ Even if it qualifies under these standards, any individual grant also must be tested by the standards described above in *Prohibitions Against Self-Dealing*.

not to be interpreted as making the granting foundation an insurer of the activity of the organization to which it makes a grant, so long as the granting foundation uses reasonable efforts and establishes adequate procedures so that the funds will be used for proper charitable purposes. In effect, "prudent man" standards are required in such cases. One way of obtaining this assurance is to obtain independent audits from the donee organization as to the use of the funds in question.

These special requirements apply to foundation grants to (1) other private foundations (operating or nonoperating), (2) organizations exempt from tax under provisions of the code other than section 501(c)(3), and (3) organizations which are not exempt from tax. With the minor exception of organizations testing for public safety, the "expenditure responsibility" requirements do not apply to grants to section 501(c)(3) organizations which are not themselves private foundations. Hence, for example, a foundation making a grant to an educational institution or a publicly supported charity need not require or make the reports prescribed by this provision. Furthermore, where a foundation makes a grant to such an organization in good faith for purposes proper for the granting foundation, the subsequent use of the funds by the recipient institution is the responsibility of that institution alone, and does not produce tax consequences (under this section) for the grantor or its managers.

It is contemplated that a foundation will be required to specify the purposes of any grant clearly in the terms of the grant itself. The terms of the grant should, also, state plainly the limitations upon the recipient's use of the grant. After the grant is made, the granting foundation must take reasonable steps (a) to secure reports from the grantee on its use of the funds, and (b) to report to the Internal Revenue Service the amount and purposes of the grant, the identity of the grantee, and the data which the grantor obtains on the grantee's use of the funds. The Internal Revenue Service is expected to provide an appropriate schedule or attachment for the annual information return, so that all reports which a grant-making foundation must make to the Internal Revenue Service for 1 year can be consolidated in the foundation's information return for that year. If the grantor discovers a misapplication of the funds by the grantee, it would normally be required to withhold any further payments to the grantee (to the extent that it is legally able to do so) until the misapplication has been corrected, or adequate assurance provided that it will not occur again. Where a grantor foundation adheres to these rules, and a misuse occurs which it has no reasonable means of correcting, it will be deemed to have discharged all responsibilities under this section by reporting the default to the Internal Revenue Service.

The Congress concluded that the "expenditure responsibility" requirement of the Act properly accommodates the needs for both flexibility and responsibility.

Although the law requires exempt organizations to be operated "exclusively" for the specified charitable purposes, the courts have held that this precludes noncharitable purposes only if they are substantial. The Congress did not seek to disturb that interpretation insofar as it relates to determining loss of, or qualification for, exemption. However, all private foundation expenditures for purposes other

than those listed in section 501(a)(3) are subject to the sanctions of this provision.²⁴

In the case of expenditures for activities prohibited by this section, the Act provides an initial sanction of 10 percent of the amount improperly spent (plus a tax of 2½ percent up to a maximum of \$5,000 on any foundation manager who knowingly made the improper expenditure). A heavier sanction of 100 percent is applicable later only if the foundation refuses to correct the earlier improper action to the extent possible. If full recovery of the improper expenditure is not possible, then, in order to avoid the heavier sanction, the foundation must take such corrective action as the Internal Revenue Service requires by regulations. A heavier sanction on the manager (50 percent of the taxable expenditure—not to exceed \$10,000) applies only if he refuses to agree to part or all of the correction. The time for correcting improper expenditures for lobbying, electioneering, individual grants, and grants to other organizations may not be extended by the Internal Revenue Service merely because a State official has undertaken to involve his office in the matter. However, action by a State official to preserve assets for charity (for example, by substituting trustees) may be sufficient reason for extending the correction period if the expenditure was improper solely because it was not for a section 170(c)(2)(B) purpose.

Provisions regarding penalties for repeated or flagrant violations, third-level sanctions, court review, and governing instrument provisions, are essentially the same as those applying to self-dealing.

Effective date.—This provision took effect on January 1, 1970.

7. Disclosure and Publicity Requirements (secs. 101 (d) and (e) of the Act and secs. 6033, 6034, 6056, 6104, 6652, 6685, and 7207 of the code)

Prior law.—Under prior law, an exempt organization was required to file annual information returns showing its gross income, expenses, disbursements for its exempt purposes, accumulations, balance sheet, and the total amount of contributions and gifts received by it during the year. This requirement applied only to exempt organizations (under section 501(a)) other than religious organizations and certain of their affiliates, schools and colleges, publicly supported charitable organizations, certain fraternal beneficiary societies, and federally-owned congressionally chartered exempt corporations. These information returns were in addition to the unrelated business income returns required to be filed in certain cases.

No specific sanctions were provided for failure to file an exempt organization information return. However, certain criminal provisions could be applied in extreme cases.

Prior law also provided that the information required to be furnished on exempt organization information returns was open to the public.

General reasons for change.—The prior information return requirements were essentially the same as those provided by the 1950 amendments to the charitable organization provisions of the code. The primary purpose of these requirements was to provide the Internal Revenue Service with the information needed to enforce the tax laws. The Congress concluded that experience of the past two decades

²⁴ Section 504, which prohibits the use of accumulated income to a substantial degree for non-501(c)(3) purposes, is repealed.

indicated that more information is needed on a more current basis from more organizations and that this information should be made more readily available to the public, including State officials.

Explanation of provisions.—The Act makes several changes in the disclosure and publicity provisions. It requires that information returns are to be filed by additional exempt organizations; that additional information is to be supplied on the returns; that \$10 per day is to be paid if the returns are not timely filed; that the information is to be furnished to appropriate State officials; and that private foundations will have to file and make available to the public additional detailed annual reports.

The Act provides that, with certain exceptions, every exempt organization must file an annual information return. Four categories of exceptions are provided to this substantial expansion of prior law.²⁵ Churches, their integrated auxiliary organizations, and conventions and associations of churches comprise the first category of exceptions from the requirement of filing this annual information return. Among the auxiliary organizations to which this exception applies are the mission societies and the church's religious schools, youth groups, and men's and women's organizations, and interchurch organizations of local units qualifying as local auxiliaries. The second category of exceptions from the requirement of filing this annual information return is comprised of organizations that normally have gross receipts of \$5,000 or less where the organization is of a type not required to file an information return under prior law. A third category of exceptions from the filing requirement is provided for any religious order with respect to its exclusively religious activities (but not including any educational, charitable, or other exempt activities which would serve as a basis of exemption under section 501(c)(3) if an organization which is not a religious organization is required to report with respect to such activities). In addition to these three categories, the Treasury Department may exempt other types of organizations from the filing requirements if it concludes that the information is not of significant value. Administrative exceptions may permit groups of affiliated organizations (such as religious organizations, or chapters, lodges, etc., of national organizations) to file the equivalent of consolidated returns.

A second change in prior law which the Act makes requires that there be shown on each information return the names and addresses of all substantial contributors, directors, trustees, and other management officials and of highly compensated employees. Compensation and other payments to managers and highly compensated employees also must be shown. All this information is to be available to the public, except for the names and addresses of substantial contributors to exempt organizations other than private foundations. (The non-private foundations, are, however, required to disclose those names to the Internal Revenue Service.)

A third change in prior law which the Act makes provides that the failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of \$10 per day up to a maximum of \$5,000 as to any one return, imposed on the organization.

²⁵ Even though an organization may thus avoid filing information returns, if it is engaged in an unrelated business, it still must file an unrelated business income tax return.

The same sanction is to apply also to a trust that fails to file on a timely basis the special information return required as to its deductible charitable contributions.

Failure to file after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of \$10 a day to a maximum of \$5,000 as to any one return. This sanction is imposed on the exempt organization official or employee who fails to file the information return.

The fourth change which the Act makes directs the Internal Revenue Service to notify State officials of (a) any refusal by the Service to recognize the exempt status of a section 501(c)(3) organization previously exempt or applying for recognition of its exemption, (b) any violation by an organization of the requirements of its exemption, and (c) any mailing of a notice of deficiency regarding any of the new taxes imposed by this Act with respect to private foundations. In addition, the Service is to make available information about the items previously referred to that are relevant to any determination under State law.

A fifth change in prior law provides that every private foundation with at least \$5,000 of assets at any time during the year is required to file an annual report in addition to the information return described above. It is expected that the Service will make available a single form that may be used by a private foundation to meet both of these filing requirements. The principal additional information items required in the annual report are: (a) itemized lists of assets showing book and market values, (b) itemized lists of grants, amounts and purposes thereof, grantees' names, addresses, and relationship to the foundation's managers or substantial contributors, and (c) lists of all foundation managers who are substantial contributors or who own at least 10 percent of any corporation, partnership, or other entity in which the foundation owns at least 10 percent.

In addition to being filed with the Service, a copy of the annual report must be made available to any citizen at the foundation's office for at least 180 days and the foundation must publicize its availability. Failure to comply (that is, to file the annual report or to make it publicly available) results in a sanction of \$10 per day (to a maximum of \$5,000) as to each such report; willful failure results, in addition, in a penalty of \$1,000, as does the willful furnishing of fraudulent or false information. These annual reports are subject to public inspection, as in the case of information returns, and are to be furnished to appropriate State officials.

Effective date.—The disclosure provisions apply to taxable years beginning after December 31, 1969. The publicity provisions, including the requirement of notifying State officials, took effect January 1, 1970.

8. Termination of Private Foundation Status and Certain Other Rules With Respect to Sec. 501(c)(3) Organizations (sec. 101(a) of the Act and secs. 507, 508, and 509(b) and (c) of the code)

Prior law.—Under prior law, an organization was exempt if it met the requirements of the code, whether or not it sought an "exemption certificate" from the Internal Revenue Service.

If an organization did not continue to meet the requirements for exemption, if it committed certain specifically prohibited acts (sec.

503), or if it dealt in certain prohibited ways with its accumulated earnings (sec. 504), it lost its exempt status. This loss of exempt status might relate back to the time the organization first violated the code's requirements. However, if the violation occurred after the contributions had been made to the organization, no deductions were disallowed to such contributors. Also, the organization's income tax exemption was not disturbed for years before the organization's first violation.

General reasons for change.—The Congress believed that the Internal Revenue Service was handicapped in evaluating and administering the tax laws by the lack of information with respect to many organizations.

In addition, Congress was concerned that in many cases under prior law the loss of exempt status would impose only a light burden on many foundations. This was true in those circumstances, for example, where the foundation had already received sufficient charitable contributions to provide its endowment and where the foundation could retain its exemption as to its current income by qualifying under an exemption category other than section 501(c)(3).

Explanation of provisions.—The Act requires new exempt organizations to notify the Internal Revenue Service that they are applying for recognition of their section 501(c)(3) exempt status. New and existing organizations also must notify the Service if they claim to be other than private foundations. Exceptions to these rules are made in the case of churches and may be made in the cases of schools and other classes of organizations where the Treasury determines full compliance is not necessary to efficient administration. If an organization wishes to avoid the limitations imposed upon private foundations, or if an organization persistently violates these limitations, it must repay all the tax benefits that it and its substantial contributors have received.

An organization organized after October 9, 1969, is not to be treated as exempt under section 501(c)(3) unless it has notified the Internal Revenue Service that it is applying for recognition of its exempt status. As under prior law, the nature of the organization itself—not the determination of the Service—controls in determining whether the organization is exempt. However, unlike prior law, an organization is not exempt under section 501(c)(3) if it fails to make its existence and claimed status known.

A similar requirement applies to an organization's status as a private foundation, except that (1) existing section 501(c)(3) organizations, as well as new ones, must notify the Service if they consider themselves to be "public charities" and (2) failure to make this notification results in a presumption that the organization is a private foundation. This notice is not to be required by the Internal Revenue Service, however, until at least 90 days after the regulations on this point become final.

These notice requirements do not apply to churches and their integrated auxiliaries (see discussion on this point under *Disclosure and Publicity Requirements*), to conventions or associations of churches, and to organizations (other than private foundations) whose annual gross receipts normally are not more than \$5,000. In addition, the Treasury Department may by regulations provide exemptions from these filing requirements for schools and colleges and for any other class of organization where the Treasury determines that full compliance with these provisions is not necessary to efficient administration.

The Congress concluded that foundations should not receive substantial and continuing tax benefits in exchange for the promise of use of the assets involved for educational, charitable, religious, etc., purposes but avoid the carrying out of these responsibilities. Accordingly, the Act provides that an organization which was a private foundation on October 9, 1969, or becomes one thereafter may not change its status as a private foundation unless it repays to the government the aggregate tax benefits (with interest) which have resulted from its exempt status. (However, such an organization may change its status to a public charity by the end of its first taxable year beginning after December 31, 1969, without becoming liable for this tax.) The Internal Revenue Service may also assess this tax in any case where the private foundation has willfully engaged in flagrant or repeated acts (or failures to act) giving rise to tax liability under the other provisions relating to private foundations.

The tax benefits to be repaid in such a case are all of the increases in income, estate, and gift taxes which would have been imposed upon the organization and all substantial contributors²⁶ if the organization had been liable for income taxes and if its contributors had not received deductions for contributions to the organization. If the foundation is a trust, then the foundation's own income tax benefit is the amount by which its income taxes were reduced because it was permitted to deduct charitable contributions in excess of 20 percent of its taxable income. For purposes of computing the amount of the aggregate tax benefits, all benefits available to the private foundation for taxable years beginning after December 31, 1912, and all tax benefits on contributions made to the foundation after February 28, 1913, are included. In addition, interest on all such benefits is to be added to the amount of the benefits computed, in the case of each benefit, from the first date on which the added tax would have been due if the benefit had not been available.

The amount of this tax is not to exceed the value of the net assets of the foundation determined either as of the first day on which action is taken by the foundation culminating in its loss of exempt status (under sec. 501(c)(3)) or as of the day on which it ceases to be such an organization, whichever is higher.

If a private foundation is required to pay this tax or volunteers to pay this tax to change its status, the Internal Revenue Service may then abate any part of the tax which has not been paid if (1) the foundation distributes all of its net assets to organizations which have been public charities for at least 5 years, or (2) itself has operated as a section 501(c)(3) organization which is not a private foundation for at least five years. Where a private foundation (which has not willfully and repeatedly or flagrantly violated these provisions) volunteers to change its status by acting in all respects as a public charity for at least five consecutive years the foundation is to be classified as a public charity *during* the five-year period. In order to facilitate administration of this provision, the foundation must notify the Service of its intentions before the start of the five years. Should the organization fail to act as a public charity during that period, it would lose its status as of that time as a public charity. At that time, its private foundation status would be applied as if it had never achieved status as a public charity for purposes of the change of status rules, which

²⁶ See discussion above, in *Prohibitions Against Self-Dealing*, for definition of "substantial contributor."

thus would apply from its original inception if it engages in willful and flagrant or willful repeated violations.

In the case of a distribution to other public charities, abatement of the tax is permitted only if the recipient organizations have been public charities for at least five consecutive years.

The exercise of discretion with respect to abatement of the tax will depend upon the extent to which effective assurance can be given that the assets and organizational structure dedicated to charity will in fact be used for charity. It is expected that effective assurances are most apt to be available in those States where there is vigorous enforcement of strong State laws by the State attorney general or other appropriate official. In order to encourage and facilitate effective State involvement, the Act contains as an additional condition of exemption for private foundations, a requirement that the governing instrument require current distributions of income (sec. 4942) and prohibit self-dealing (sec. 4941), retention of excess business holdings (sec. 4943), speculative investments (sec. 4944), and taxable expenditures (sec. 4945). Existing private foundations are given time to modify their governing instruments. The Congress intends and expects that this requirement will add to the enforcement tools available to State officials charged with supervision of charitable organizations. Consistent with this approach, the Act permits the tax on change of status to be abated if the Internal Revenue Service is satisfied that corrective action to preserve the foundation's assets for charity has been taken by the State attorney general or other appropriate State official under the supervision of the appropriate courts.

Internal Revenue Service administration of these provisions is further assisted by requiring a special information return to be filed by an exempt organization upon its liquidation, dissolution, termination, or substantial contraction. (Similar requirements apply to taxable corporations.)

Effective date.—These provisions generally took effect on January 1, 1970, but sections 508 (a), (b), and (c) took effect on October 9, 1969.

9. Private Foundation Definition (secs. 101(a) and (b) of the Act and secs. 509(a) and 4948 of the code)

Prior law.—“Private foundation”, a term not found in prior law, was often used to describe an organization contributions to which may be deducted only up to 20 percent of an individual donor's adjusted gross income. Deductions of up to 30 percent of a donor's income could be taken under prior law for contributions to (1) churches, (2) schools, (3) hospitals, (4) fund-raisers for schools, (5) States and subdivisions, and (6) publicly supported charities.

General reasons for change.—In general, the problems that gave rise to the remedial provisions of the Act affecting foundations discussed above appeared to be especially prevalent in the case of organizations in the 20-percent deduction group. However, it appeared that certain other organizations in the 20-percent deduction category generally did not give rise to these problems.

Explanation of provisions.—The Act provides that private foundations subject to the provisions described in the preceding parts of this general explanation are organizations described in section 501 (c)(3) other than:

(1) organizations, contributions to which may be deducted to the extent of 50 percent (30 percent under prior law) of an individual's income (this includes the six categories of organizations listed in *Prior law*, above);

(2) certain other types of broadly, publicly supported organizations described below;

(3) organizations organized and operated exclusively for the benefit of one or more organizations described in (1) or (2) above which are operated, supervised, or controlled by or in connection with one or more of these organizations²⁷ and are not controlled by disqualified persons (other than foundation managers, disqualified only as such, and organizations described in (1) or (2) above); and

(4) organizations which are organized and operated exclusively for testing for public safety.

The first and fourth categories are essentially the same as in prior law. The second category excludes from private foundation treatment any organization (including a membership organization) which normally receives no more than one-third of its support in each year from gross investment income, if more than one-third of its support comes from the public (in the form of gifts, grants, contributions, membership fees, and gross receipts from admissions and other related activities) not taking into account amounts received from disqualified persons. This requirement is designed to insure that the organization is responsive to the general public. The remainder of the organization's support may come from substantial contributors and other disqualified persons.

In defining support for purposes of this provision, the Act adopts the definition contained in the current charitable contribution regulations, modified to include in support amounts received from the exercise or performance by an organization of its exempt purpose or function.

Under the Act, the support tests are generally computed on the basis of the nature of the organization's "normal" sources of support. It is recognized that in most cases the proportions of support an organization receives from different sources will vary from year to year. Under existing law (not changed from prior law on this point) an organization's "normal" source of support is considered in determining if it is a publicly supported organization. Existing regulations²⁸ determine what is "normal" on the basis of a 4-year moving average. In general, the Congress anticipates that this approach will be used in applying the "normal" tests of the Act. Appropriate modifications are expected to be made, however, to take into account the likelihood that on occasion an organization may receive an unusual grant or bequest which should not affect its status. For example, one approach could be to determine whether the organization meets the support test in 3 out of 4 consecutive years.

In defining the one-third of the organization's support which must come from the public, the Act includes gross receipts from activities

²⁷ Under the Act, an organization can also escape private foundation status by qualifying under the third category as an "affiliate" of one or more organizations described in sections 501(c)(4) (social welfare organizations), 501(c)(5) (labor unions and granges), and 501(c)(6) (chambers of commerce and trade associations). In such a case, the section 501(c)(4), (5), or (6) organization must itself be broadly, publicly supported to such an extent that, if it were exempt under section 501(c)(3), it would meet the standards of the second category, described in the text.

²⁸ Regs. sec. 1.170-2(b)(5)(iii).

by the organization which are not unrelated trade or business activities. This, however, does not include receipts in the year from any persons or governmental agencies which exceed the greater of 1 percent of the organization's support or \$5,000.

Any gross investment income distributed by a charitable trust which is not exempt from taxation under section 501(a) to another organization retains its character as gross investment income with respect to the recipient organization for purposes of the one-third limit on gross investment income. This will prevent a private foundation from avoiding the one-third limit by transferring its endowment to a trust and will also prevent the trust from avoiding the restrictions in the bill by the assertion that it is operating for the benefit of an organization that is not a private foundation.

The organizations usually excluded from the definition of private foundations, if they satisfy this provision, include symphony societies, garden clubs, alumni associations, Boy Scouts, Parent-Teacher Associations, and many other membership organizations.

Another category of organizations removed from the definition of private foundations comprises those organizations which are organized and operated exclusively for the benefit of one or more of the 50-percent organizations or broadly based organizations described above, provided that they are operated, supervised, or controlled by or in connection with one or more such organizations, and are not controlled directly or indirectly by disqualified persons (other than foundation managers, 50-percent organizations, and broadly based organizations described above).²⁹ In general, religious organizations other than churches, the Hershey Trust (which is organized and operated for the benefit of a specific school for orphaned boys and is controlled by or operated in connection with that school), university presses, and similar organizations are examples of organizations expected to qualify for this category.

Under the Act, if an organization formed outside the United States meets the definition of a private foundation, it is to be treated as such despite the place of its organization. Accordingly, a gift by a domestic private foundation to a foreign nonoperating private foundation is a qualifying distribution only if the "1-year passthrough" requirement is met, but a gift to a foreign operating foundation qualifies under the same circumstances that a gift to a domestic operating foundation would qualify.

The Act includes a series of modifications of the private foundation rules to take account of the fact that some of the rules could not easily be applied in practice to foreign foundations. In their case the 4-percent tax is to be applied to the gross investment income received from sources within the United States. The requirements regarding change of status, governing instruments, self-dealing, minimum distributions, excess business holdings, jeopardy investments, and limitations on activities do not apply to a foreign private foundation if no significant part of its support (other than gross investment income) is derived from U.S. sources. However, in general,

²⁹ This third category applies to organizations "organized, and at all times thereafter . . . operated, exclusively for the benefit of . . . one or more specified organizations" in the first and second categories. In the case of existing organizations, these tests apply as of the effective date of the provision (Jan. 1, 1970), and an organization may qualify even though its original governing instrument did not so limit its purposes and even though it operated before the effective date for some other exempt purposes. However, this does not change the basic requirement for exemption in section 501(c)(3) that the organizations have been organized and operated exclusively for the exempt purposes listed in that provision.

such a foreign private foundation will lose its exemption under the Internal Revenue Code if it engages in any of the acts that would have justified a doubling of the taxes imposed upon the organization or upon a disqualified person or imposition of a termination tax (repayment of prior tax benefits) upon the organization (that is, repeated or willful and flagrant violations), had it been a domestic organization engaging in those same acts. Also, no income, gift, or estate tax deductions are allowed to a foreign organization that has lost its exempt status under these circumstances. In effect, such an organization is treated as a taxable nonresident alien.

Effective date.—The basic definition provisions took effect January 1, 1970. If an organization were a private foundation on October 9, 1969, then it continues to be a private foundation for purposes of these provisions until its status is terminated in the manner described above, in *Termination of Private Foundation Status*. The foreign foundation provisions apply to taxable years beginning after December 31, 1969.

10. Private Operating Foundation Definition (sec. 101(b) of the Act and sec. 4942(j) of the code)

Prior law.—The term “operating foundation” was not in prior law but was sometimes used to describe the type of organization contributions to which qualified for the unlimited charitable contribution deduction (repealed by sec. 201(a) of the Act for taxable years beginning after Dec. 31, 1974) even though they did not qualify for the 30-percent deduction provision of prior law. Essentially these were organizations which, although lacking general public support, devoted most of their earnings and much of their assets directly to the conduct of their educational, charitable, and religious purposes, as distinct from merely making grants to other organizations for these purposes. More specifically, in order to qualify for this treatment under prior law, substantially more than half of the organization’s assets and substantially all of its income must have been used or expended “directly for, the active conduct of the activities constituting the purpose or function for which it is organized and operated.”

General reasons for change.—A definition of an operating foundation is needed under the Act: First, because an operating foundation (as distinct from private foundations generally) can be the recipient of grants from a private foundation without having to spend the funds so received currently within one year, with the funds nevertheless qualifying as expenditures of income by the donating private foundation. Second, charitable contribution donations to operating foundations are eligible for the 50-percent charitable contribution deduction. Third, while an operating foundation is required to spend or use substantially all its income for the active conduct of its educational or charitable purposes, it is not subject to the 6-percent minimum payout requirement nor required to expend its entire income.

Explanation of provisions.—The Act provides that an operating foundation is a private foundation at least 85 percent of whose income is spent directly for the active conduct of its activities representing the purpose or function for which it is organized and operated. The foundation must also meet one of three other tests. The first of these alternative tests requires that at least 65 percent of the assets of the foundation must be devoted directly to the activities for which it is organized or to functionally related businesses. (This alternative is essentially the same as prior law.) The second alternative covers cases

where the organization normally receives substantially all of its support (other than gross investment income) from five or more exempt organizations and from the general public. In this case not more than 25 percent of the foundation's support (other than gross investment income) may be received from any one of these exempt organizations and not more than half of its support may come from its investment income. This second alternative was added because it appeared that a number of charitable foundations were regularly used by many private foundations to funnel charitable contributions into certain areas. The operating foundations in such circumstances have developed an expertise which permits them to make effective use of the money through grant programs or otherwise.

The third alternative which the Act provides is where an organization's endowment (plus any other assets not devoted directly to the active conduct of the activities for which it is organized), based upon a 4-percent rate of return, is no more than adequate to meet its current operating expenses. (The 4-percent rate will vary in accordance with any changes made by the Secretary of the Treasury in the 6-percent minimum payout requirement and will be two-thirds of the minimum payout requirement rate.)

This definition retains the concept that the income of the organization must be expended currently for its specialized purposes. The assets alternative is intended to apply particularly to organizations such as museums, Callaway Gardens (a horticultural and recreational area for the use of the public at Pine Mountain, Ga.), Colonial Williamsburg (described above in *Taxes on Excess Business Holdings*), and Jackson Hole (which operates functionally related businesses in connection with public parks and its exempt purposes).

The support alternative is intended to focus primarily upon special-purpose foundations, such as learned societies, associations of libraries, and organizations which have developed an expertise in certain substantive areas and which provide for the independent granting of funds and direction of research in those specialized substantive areas. (See *Taxes on Certain Expenditures of Foundations*, above.)

The endowment alternative is intended to apply to organizations which actively conduct charitable activities (as distinguished from merely making grants) but where their personal services are so great in relationship to charitable assets that the cost of those services cannot be met out of small endowments. Examples of organizations to which this alternative is expected to apply include Longwood Gardens, Sleepy Hollow Restoration, and research organizations.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

11. Effective Dates (secs. 101(k) and (l) of the Act)

The provisions described above generally took effect on January 1, 1970. However, the tax on investment income, the income distribution and excess business holdings requirements, and the foreign foundation provisions apply to taxable years beginning after December 31, 1969.

The self-dealing rules are delayed in certain circumstances to permit sales of existing excess business holdings to disqualified persons and to facilitate orderly disengagement from existing leases, loans, other extensions of credit, and sharing of services or facilities. (These provisions were described above in No. 2 "*Prohibition Against Self-Dealing.*")

The minimum distribution rule is phased in for existing foundations. Also that rule is not to apply until taxable years beginning after December 31, 1971, to foundations organized before May 27, 1969, whose governing instruments (in effect on May 26, 1969) require accumulations of income or forbid invasions of corpus, to the extent the provisions of these instruments conflict with the Act. The accumulations exception may be extended indefinitely if revision of the governing instrument or excuse from compliance with its terms cannot be effected; the corpus invasion exception may be extended only so long as is reasonably necessary to complete judicial proceedings to revise the instrument or excuse noncompliance.

Special provisions partially excuse a private foundation under certain circumstances from complying with the excess business holdings rules. Other special provisions permit a private foundation under certain circumstances to elect during 1970 to not have the private foundations provisions apply to it, but if the organization so elects, it thereafter cannot be exempt under section 501(a) of the code unless it first complies with the requirements for termination of foundation status, described above.

B. OTHER TAX-EXEMPT ORGANIZATIONS

1. The "Clay Brown" provision or Debt-financed Property (sec. 121(d) of the Act and secs. 512 and 514 of the code)

Prior law.—Under prior law, charities and some of the other types of exempt organizations were subject to tax on rental income from real property to the extent the property was acquired with borrowed money. However, this provision did not apply to all tax-exempt organizations, and there was an important exception which excluded rental income from a lease of 5 years or less. In addition, there was a question as to whether the tax applied to income from the leasing by a tax-exempt organization of assets constituting a going business.

General reasons for change.—During the past several years weaknesses in the prior provision relating to debt-financed property were exploited in several different respects. As a result, a large number of tax-exempt organizations used their tax-exempt privileges to buy businesses and investments on credit, frequently at what was more than the market price, while contributing little or nothing themselves to the transaction other than their tax exemption.

¶ In a typical *Clay Brown* situation a corporate business was sold to a charitable or educational foundation, which made a small or no down payment and agreed to pay the balance of the purchase price out of profits from the property. The charitable or educational foundation liquidated the corporation, leased the business assets back to the seller, who formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as "rent" to the foundation, which then paid most of these receipts back to the original owner as installment payments on the initial purchase price.

In this manner in the *Clay Brown* case (1965 Supreme Court case), a business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business valued at \$1.3 million, without the investment of its own funds. In the more recent (1969) *University Hill Foundation* case, the Tax Court upheld

the acquisition of 24 businesses by the University Hill Foundation in the period 1945 to 1954. Other variants of the debt-financed property problem have also been used.

Explanation of provision.—The Act provides that all exempt organizations' income from "debt-financed" property, which is unrelated to their exempt function, is to be subject to tax in the proportion in which the property is financed by the debt. Thus, for example, if a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are to be taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes. Capital gains on the sale of debt-financed property are also taxed in the same proportions.

The Act defines debt-financed property to be all property (e.g., rental real estate, tangible personal property, corporate stock) which is held to produce income and with respect to which there is an "acquisition indebtedness" at any time during the taxable year (or during the preceding 12 months, if the property is disposed of during the year).

The Act excepts from this definition the following: (1) property where "substantially" all of its use is substantially related to the exercise or performance of the organization's exempt purpose or if less than substantially all of its use is related, then to the extent that its use is related to the organization's exempt purpose; (2) property to the extent that its income is already subject to tax as income from the conduct of an unrelated trade or business; (3) property to the extent that its income is derived from research activities excepted from the present unrelated business income tax; and (4) property to the extent that its use is in a trade or business exempted from tax because substantially all the work is performed without compensation, the business is carried on primarily for the convenience of members, students, patients, etc., or the business is the selling of merchandise, substantially all of which was received as gifts (sec. 513(a)(1), (2), and (3)).

For purposes of (1) above, substantially all the use of a property is considered substantially related to the exercise or performance of the organization's exempt purpose, for example, where the property is real property subject to a lease to a medical clinic and where the lease is entered into primarily for purposes which are substantially related to the lessor's exempt purposes.

The Act also provides that where a debt-financed building is owned by an exempt holding company (or other exempt organization) and used by any related exempt organization, the property of the holding company (or other exempt organization) is not to be classified as debt-financed property to the extent it is used by the related exempt organization (whether or not a section 501(c)(3) organization) in the performance of its exempt functions.

The Act further provides that the tax on unrelated debt-financed income is not to apply to income from real property, located in the neighborhood of the exempt organization, which it plans to devote to exempt uses within 10 years of the time of acquisition. A more liberal 15-year rule is established for churches, and it is not required that the property be in the neighborhood of the church.

Income producing property is considered to be debt-financed property (making income from it taxable) only where there is an "acqui-

tion indebtedness" attributable to it. Acquisition indebtedness exists with respect to property whenever the indebtedness was incurred in acquiring or improving the property, or the indebtedness would not have been incurred "but for" the acquisition or improvement of the property. Thus, for example, where a church has a portfolio of investments with no debt, and subsequently incurs a debt to construct a church related building, such as a seminary, such debt will not be considered acquisition indebtedness with respect to the investment portfolio.

If an indebtedness is incurred after the property is acquired or improved, it would not be "acquisition indebtedness" unless its incurrence was reasonably foreseeable at the time of the acquisition or improvement. If property is acquired subject to a mortgage, the mortgage is to be treated as an acquisition indebtedness incurred by the organization when the property is acquired.

Under the Act, as indicated above, unrelated debt-financed income will be subject to tax only if the income arises from property acquired or improved with borrowed funds and the production of the income is unrelated to the educational, charitable, religious, or other purpose constituting the basis of the organization's tax exemption. For example, where a charitable organization pledges recently acquired property to borrow funds which it immediately uses for its tax exempt purposes and neither the donor of the pledged property nor any other private individual receive any direct or indirect financial benefit (either as a result of the transfer of the property or the borrowing by the organization) it will be assumed that the borrowing is for the organization's exempt purposes. Of course, this could not be used to circumvent this provision where investment property is also acquired and the borrowing would not have occurred but for the investment property acquisition.

The Act, for a period of time, excepts from the term "acquisition indebtedness" property subject to indebtedness which an exempt organization receives by devise, by bequest, or, under certain conditions, by gift. This exception permits organizations receiving such property a 10-year period of time within which to dispose of it free of tax or to retain it and reduce or discharge the indebtedness on it with tax-free income. The Act also would not treat the extension, renewal, or refinancing of an existing indebtedness as the creation of a new indebtedness. Further, the term acquisition indebtedness does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption—such as the indebtedness incurred by a credit union in accepting deposits from its members. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low and moderate income housing.¹

¹The Act excepts from the term "acquisition indebtedness" an obligation to pay an annuity which (1) is the sole consideration issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90 percent of the value of the property received in the exchange, (2) is payable over the life of one individual who is living at the time the annuity is issued, or over the lives of two individuals living at such time, and (3) is payable under a contract which does not guarantee a minimum amount of payments or specify a maximum amount of payments and does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property. The term "acquisition indebtedness" also does not include an obligation to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons to the extent that it is insured by the Federal Housing Administration.

The intent of Congress is that property acquired under a life income contract is not to be treated as debt-financed property if none of the payments received by any life beneficiary are treated for tax purposes as the proceeds of a sale or exchange of part or all of the property transferred to the exempt organization. Under a life income contract, an individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to the donor, or to other private persons, for a period of time (generally for life) with the remainder interest going to charity. These life income contracts do not represent the type of obligation intended to be treated as "acquisition indebtedness."

The computation of unrelated debt-financed income (the amount subject to tax) is determined by applying to the total gross income and deductions attributable to debt-financed property the fraction:

$$\frac{\text{average acquisition indebtedness for the taxable year}}{\text{average adjusted basis of the property during the taxable year}}$$

For purposes of the numerator of the fraction, acquisition indebtedness is to be averaged over the taxable year. The averaging mechanism precludes an exempt organization from avoiding the tax by using other available funds to pay off the indebtedness immediately before any fixed determination date. If debt-financed property is disposed of during the year, "average acquisition indebtedness" would mean the highest acquisition indebtedness during the preceding 12 months. Without such a rule, an exempt organization could avoid tax by using other resources to discharge indebtedness before the end of one taxable year and dispose of property after the beginning of the next taxable year.

For purposes of the denominator of the fraction, adjusted basis would be the average adjusted basis for the portion of the year during which the property is held by the exempt organization. The use of average adjusted basis is for purposes only of determining the fraction. Where property is disposed of, gain or loss will, as usual, be computed with reference to adjusted basis at the time of disposition.

If property is distributed by a corporation in liquidation to the exempt organization, the exempt organization is to use the basis of the distributing corporation, with adjustment for any gain recognized on the distribution either to the exempt organization (as, for example, might be the case if the exempt organization had an acquisition indebtedness applicable to its stock in the distributing corporation) or to the taxable corporation (for example, as recapture of depreciation under sections 1245 or 1250). This rule would prevent an exempt organization from acquiring the property in a taxable subsidiary to secure accelerated depreciation during the first several years of the life of the property, enabling the subsidiary to pay off a large part of the indebtedness during those years after which the exempt organization would obtain a stepped-up basis on liquidation of the subsidiary.

The percentage used in determining the taxable portion of total gross income also is to be used to compute the allowable portion of deductions "directly connected with" the debt-financed property or the income from it. The direct connection requirement is carried over from existing law (sec. 512). In general, the Act allows all deductions that would be allowed to a normal taxpayer, to the extent consistent with

the purpose of the Act and the nature of the special problems to which they are directed. For example, net operating loss and charitable contribution deductions are allowed, subject to the limitations imposed by existing law on organizations taxable on unrelated business income (e.g., the percentage limitations on the charitable deduction are computed with reference only to the organization's unrelated business income, not its total income).

The deduction for depreciation is restricted to the straight-line method, however. Accelerated depreciation ordinarily has the effect of deferring tax on income from depreciable property. However, under the Act, an exempt organization becomes a taxpayer with respect to the debt-financed property only for a limited period of time—while acquisition indebtedness remains outstanding—and during that time is taxed on a declining proportion of its income from this property. In that setting, accelerated depreciation could be used for more than mere tax deferral; it could be used to reduce the total amount of the tax payable or, in some situations, to eliminate tax altogether. It would accomplish that result by enlarging deductions in early years, in which the taxes would otherwise be high because of the large amount of indebtedness outstanding. To the extent that the useful life of the property is longer than the term of the indebtedness, acceleration of depreciation would shield otherwise taxable income by means of reductions shifted from periods in which no tax at all would be paid. Hence, the Act's limitation of depreciation to the straight-line method is necessary to make this approach meaningful.

If property is used partly for exempt and partly for nonexempt purposes, the income and deductions attributable to the exempt uses are excluded from the computation of unrelated debt-financed income, and allocations are made, where appropriate, for acquisition indebtedness, adjusted basis, and deductions assignable to the property.

The provision is generally effective for 1970 and later years, but for years before 1972 only indebtedness incurred on or after June 28, 1966, is to be taken into account.

2. Extension of Unrelated Business Income Tax to All Exempt Organizations (secs. 121 (a), (b), and (f) of the Act and secs. 511 and 512 of the code)

Prior law.—Under prior law the tax on unrelated business income applied only to certain tax-exempt organizations. These included:

(a) Charitable, educational, and religious organizations (other than churches or conventions of churches);

(b) Labor and agricultural organizations;

(c) Chambers of commerce, business leagues, real estate boards, and similar organizations;

(d) Mutual organizations which insure deposits in building and loan associations and mutual savings banks; and

(e) Employees' profit sharing trusts and trusts formed to pay (non-discriminatory) supplemental unemployment compensation.

In general, the unrelated business income tax subjects these organizations to the regular corporate income tax (or the tax applicable to trusts) on their active business income which arises from activities which are unrelated to the exempt purposes of the organizations.

General reasons for change.—In recent years, many of the exempt organizations not subject to the unrelated business income tax—such as churches, social clubs, fraternal beneficiary societies, etc.—

began to engage in substantial commercial activity. For example, numerous business activities of churches were brought to the attention of the Congress. Some churches are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity.

Explanation of provision.—The Act extends the unrelated business income tax to all exempt organizations (except United States instrumentalities created and made tax exempt by a specific act of Congress). The organizations newly made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, employees' beneficiary organizations, teachers retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations.

This tax does not apply unless the business is "regularly" carried on and therefore does not apply, for example, in cases where income is derived from an annual athletic exhibition. In the case of membership organizations, income resulting from charges to members or their dependents or guests for goods, facilities, and services supplied in carrying out the exempt function is not subject to tax.

The Act continues to exclude from unrelated business income earnings from businesses related to an organization's exempt function—such as the earnings received directly or indirectly from its members by a fraternal beneficiary society in providing fraternal activities or insurance benefits for its members or their dependents. For example, if the fraternal beneficiary society directly provides insurance for its members and their dependents, or arranges with an insurance company to make group insurance available to them, the amounts received by the society from its members for providing, or from the insurance company for arranging, for this exempt function will continue to be excluded from the unrelated business income tax.

The Act contains several administrative provisions including one providing that for purposes of the unrelated business income tax no audit of a church, its integrated auxiliaries, or a convention or association of churches is to be made unless the principal internal revenue officer for the region believes the church may be engaged in a taxable activity and so notifies the church in advance of the examination. Furthermore, no examination of the religious activities of an organization is to be made unless it is necessary to determine whether the organization is a church or a convention or association of churches, and no examination of the books of account of the organization is to be made other than that necessary to determine the amount of the unrelated business income tax. This provision is intended to protect churches from unnecessary tax audits in the interest of not interfering with the internal financial matters of churches. Another provision will assist the Internal Revenue Service in its administrative functions by requiring a transferor to report a transfer of income-producing property if the transferor knows the transferee is an exempt organization and the property has a value of more than \$50,000.

The Act, in extending the unrelated business income tax to churches, provides a period of time (through taxable years beginning before January 1, 1976) for churches to dispose of unrelated businesses (operated before May 27, 1969) or to spin them off into separate taxable corporations.

Prior law, in distinguishing between passive income which is free of tax and active business income which is subject to tax, provides an exclusion from the unrelated business income tax for all rents from real property and personal property leased with the real property. The Act limits the exclusion for rents of personal property to cases where the rent from the personal property is an incidental amount of the total rent. The personal property generally is to be considered incidental if the rent attributable to it does not exceed 10 percent of the total rent received under the lease (or leases, if two or more leases are involved). Further, where the rent attributable to the personal property is 50 percent or more of the total rent, the total rent (including the rent from real property) is to be taxed. In addition, the Act taxes property rentals of both real and personal property where the rentals are measured by reference to the net income from the property. It excludes from unrelated business income, however, rentals based upon a percentage of gross receipts. This incorporates the test for "passive" rentals used in dealing with real estate investment trusts.

These provisions apply even where two or more leases are used, for example, one for the realty and another for the personalty. These provisions are intended to prevent an escape from the tax on unrelated business income in those cases where an exempt organization owns an operating business but leases the business assets to an independent management company. In such a case it receives most of the profits from the business in the form of "passive rents" and comes under the existing exclusion from real property and personalty leased with real property. The Act is not intended to create any inference as to the Tax Court decision in the *University Hill Foundation* case or other cases still in litigation.

The \$1,000 specific deduction allowed in computing the unrelated business income tax is to be available for each parish, individual church, district, or other local unit in the case of a diocese, province of a religious order or convention or association of churches. This rule is to be applicable only to the extent that the individual parish, district, etc., realizes the income from an unrelated trade or business regularly carried on by it.

Under prior law, a voluntary employees' beneficiary association (exempt under sec. 501(c)(9)) providing life, sickness, accident and other benefits to members must have derived 85 percent or more of its income from its members. With the imposition of the tax on unrelated business income on organizations in this category (and also the investment income tax referred to subsequently), Congress concluded that the 85 percent income test was no longer necessary. As a result, the tax-exempt status of voluntary employees' beneficiary associations will not depend on whether or not they meet the 85 percent test. This accords with the treatment of associations whose members are United States Government employees (sec. 501(c)(10) under prior law). For this reason, there is no substantive difference remaining between these two provisions and the Act combines these two categories.

In addition, the Act specifies that those voluntary employees' beneficiary associations which provide pension and retirement benefits for their members and which were taxed under special life insurance company provisions (secs. 801(b)(2)(B), 802 and 810(e) under prior law), are restored to an exempt category under section 501(c) (as was previously the case), but are to be subject to the unrelated business income tax. For purposes of this provision, the term retirement benefits is intended to include customary and incidental benefits, such as death benefits within the limits permissible under section 401.

In defining what constitutes unrelated business income, the Act provides that when an exempt holding company pays any amount of its net income to a tax-exempt organization, and files a consolidated return with that organization, the holding company is to be treated as organized and operated for the same purposes as the exempt organization. This means that if the income of the holding company is related to the exempt functions of the exempt organization, it is to be classified as related business income and therefore not subject to tax.

The Act provides that the unrelated business income tax is not to apply to a religious order or to an educational institution maintained by such a religious order that has operated an unrelated business, which provides services under a license issued by a Federal regulatory agency, for 10 years or more, if not less than 90 percent of the earnings from the unrelated business each year are devoted to religious, charitable, or educational purposes, and it is established to the satisfaction of the Secretary, or his delegate, that rates and other charges and services provided by such a business are fully competitive with and do not exploit similar businesses operating in the same general area.

Under prior law, an organization (known as a "feeder" organization) operated primarily to carry on a trade or business for profit has not been exempt even though all its profits were payable to one or more exempt organizations (sec. 502). On the other hand, the unrelated business income tax does not apply to a business in which substantially all the work in carrying on the business is performed for the organization without compensation or to a business (such as a thrift shop) which sells merchandise, substantially all of which is received by the organizations as gifts or contributions (sec. 513(a) (1) and (3)). These exceptions may not have applied to feeder organizations under prior law. The Act specifically extends these exceptions to such businesses, regardless of whether the business is run for the benefit of one or more exempt organizations, even though in a separate organization or otherwise.

In the case of churches, Congress intends that the term unrelated business income not include the operation and maintenance of cemeteries, the conduct of charitable institutions, the sale of religious articles and the printing, distribution and sale of religious pamphlets, tracts, calendars, papers, books and magazines with a substantial religious content (even though the document might contain a small amount of advertising), as long as these activities are carried on in connection with the church.

Congress, also, intends that when organizations send out low cost articles incidental to the solicitation of charitable contributions, the amounts received are not to be considered as being in exchange for the

low cost articles where it is clear that the contributions, less a reasonable administrative cost, fully accrue to the exempt organization.

The fact that an unrelated business income tax is payable by an organization is not intended to mean that the organization should, or should not, retain its exemption. This is to be determined on the basis of the organization's overall activities without regard to the fact that some of its activities are subject to the unrelated business income tax.

3. Taxation of Investment Income of Social Clubs and Employees' Beneficiary Associations (sec. 121(b) of the Act and 512 of the code)

Prior law.—Under prior law the investment income of social clubs and employees' beneficiary associations was exempt from income tax.

General reasons for change.—Since the tax exemption for social clubs (described in section 501(c)(7) and voluntary employee beneficiary associations (described in section 501(c)(9)) is designed, at least in part, to allow individuals to join together to provide recreational or social facilities without tax consequences, the tax exemption operates properly only where the sources of income of the organization are limited to receipts from their membership. Where an organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit from the tax-exempt funds used to provide pleasure or recreational facilities.

Explanation of provisions.—The Act provides for the taxation of the investment income of social clubs and employees' beneficiary associations. This does not apply, however, to the extent that this income is set aside to be used only for religious, charitable, scientific, literary, educational etc. purposes (the purposes specified in sec. 170(c)(4)), or for the exempt insurance function of employees beneficiary associations. If in any year, an amount is taken out of the set aside and used for any other purposes, however, this amount is then to be subject to tax.

Congress intends in the case of national organizations of college fraternities and sororities that amounts set aside for scholarships, student loans, loans on local chapter housing, leadership and citizenship schools and services, and similar activities, be classified as amounts used for educational or charitable purposes under this provision. This exception would also extend to any other educational or charitable activities of these or other exempt organizations.

The Act also provides that income will be treated as set aside for the specified benefits where it is used for the reasonable cost of administration of benefit programs, as well as the payment of the benefits themselves or the reasonable cost of administration of religious, educational or charitable activities.

In addition, the Act provides that the tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within a period beginning 1 year before the date of sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034).

For example, where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale is not to be taxed if the proceeds are reinvested in the new clubhouse within three years.

Congress in providing the tax on investment income of social clubs does not intend this to have any bearing on whether an exemption should be granted, or continued, if significant income earning activities are carried on by the organization.

The Act also provides a new category of exemption for fraternal beneficiary associations operating under the lodge system where the fraternal activities are exclusively religious, charitable or educational in nature and no insurance is provided for the members. A separate exempt category was provided for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members to describe more properly the different types of fraternal associations.

4. Interest, Rents, and Royalties From Controlled Corporations (sec. 121(b) of the Act and sec. 512 of the code)

Prior law.—Under existing law, rent, interest, and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally was not subject to tax.

General reasons for change.—Some exempt organizations “rent” their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large “rent” deduction. While courts have occasionally disallowed some, or all, of the rent deductions, the issue is a difficult one for the Internal Revenue Service.

Explanation of provisions.—The Act provides that where a tax-exempt organization owns more than 80 percent of a taxable subsidiary, the interest, annuities, royalties and rents received by it are to be treated as “unrelated business income” and are subject to tax in the hands of the exempt organizations. The deductions connected with the production of this income are allowed.

The provision provides, however, that where the subsidiary is also an exempt organization, the provision is to apply only in the proportion that the subsidiary’s income is unrelated business income to it. In addition, where the operation of a taxable controlled corporation is related to the exempt purposes of the controlling exempt organization, so that the income would not be unrelated business taxable income if derived directly by the controlling organization, the Act provides that such income from the taxable subsidiary is to be treated as related income and therefore not subject to tax in proportion to the subsidiary’s income from the related activities.

5. Limitation on Deductions of Nonexempt Membership Organizations (sec. 121(b) of the Act and sec. 277 of the code)

Prior law.—Certain nonexempt organizations which provide services to members on a nonprofit basis realize investment income, or income from providing services to nonmembers, which is used to defray all or part of the cost of providing services to members. Some

courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost. Other courts have held, instead, that such a "loss" is permissible, and that the expenses of providing such services at less than cost offset for tax purposes additional income earned by the organization from investments or other activities.

General reasons for the change.—In some cases, membership organizations, which also have business or investment income, serve their members at less than cost and offset this book loss against their business or investment income and as a result pay no income tax. In an important decision, it was held that a non-exempt water company was not subject to tax when the "losses" in supplying its members water offset its investment income. Other courts have held to the contrary.

Explanation of provision.—The Act provides that in the case of a taxable membership organization, the deduction for expenses incurred in supplying services, facilities or goods to the members is to be allowed only to the extent of the income received from these members (including in this latter category income derived during the year from institutes and trade shows which are primarily for the education of members). The purpose is to prevent membership organizations from escaping tax on business or investment income by using this income to serve its members at less than cost and then deducting the "loss from the membership activity against the investment income."

The Act does not apply to organizations that are taxable as banking institutions or insurance companies. In addition, it does not apply to a national securities exchange (subject to regulation under the Securities Exchange Act of 1934) or to a commodity market (subject to regulation under the Commodity Exchange Act).

Congress also was concerned about the application of this provision to certain nonprofit (but taxable) membership organizations (such as the American Automobile Association) which operate in competition with profitmaking organizations which provide the same type of services as a "loss-leader." Because of this, the nonprofit organization must set its dues at the same loss level. The nonprofit organization in such a case offsets the resulting losses with income received from nonmembers (such as income from the sale of advertisements concerned with travel in maps or in travel guides). To deal with this problem, the provision was made inapplicable to membership organizations which are organized without capital stock and where no part of the net earnings are distributable to any member, if the organization has elected before October 9, 1969, to report prepaid dues (under section 456) ratably over the period in which the related services are required to be rendered.

The Act provides that where the cost of furnishing services, facilities or goods to members exceeds the income from members, the excess deductions are to be carried over to succeeding years and made available in those years as offsets against income derived from members in those years.

The effective date of this provision is deferred until January 1, 1971. This will afford an opportunity to consider further adjustments in this provision to better deal with the federal income tax treatment of nonexempt membership corporations.

In adopting this provision, Congress does not intend to create any inference as to the allowability under existing law of a deduction for the excess of such costs over income from members.

6. Income from Advertising, etc. (sec. 121(c) of the Act and sec. 513 of the code)

Prior law.—In December 1967, the Treasury Department promulgated regulations under which the income from advertising and similar activities is treated as “unrelated business income” even though such advertising for example may appear in a periodical related to the educational or other exempt purpose of the organization.

General reasons for change.—While it was concluded that the regulations reached an appropriate result in specifying that in carrying on an advertising business in competition with other taxpaying advertising businesses a tax should be paid, nevertheless, the statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations.

Explanation of provision.—The Act provides that the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For this purpose, an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities which may, or may not, be related to the exempt purpose of the organization. However, where an activity carried on for profit constitutes an unrelated trade or business, no part of it is to be excluded from such classification merely because it does not result in profit.

Under this provision, advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) is to constitute unrelated business income to the extent it exceeds the expenses related to the advertising, except that if the editorial aspect of the publication is carried on at a loss, the editorial loss may also be offset against the advertising income from such publication. The language in the Act which refers to the activity “carried on for the production of income” is not intended to refer to the publishing of a magazine with little or no advertising and which is distributed free or at a nominal charge not intended to cover costs. This type of magazine would appear to be published basically as a source of public information and not for the production of income. For a publication to be considered an activity carried on for the production of income, it must be contemplated that the revenues from advertising in the publication or the revenues from sales of the publication, or both, will result in net income (although not necessarily in a particular year).

Under the Act, an organization which publishes more than one magazine, periodical, etc., may treat any of these on a consolidated basis in determining its unrelated trade or business income so long as each such periodical, etc., is “carried on for the production of income.” The organization, however, would not be permitted to consolidate the losses of a publication not carried on for the production of income with the profits of other publications which are carried on for profit.

Where an unrelated business activity, such as the sale of advertising in a publication of a tax-exempt organization is carried on in conjunction with an exempt function, the Treasury Department is to prescribe regulations indicating the appropriate methods for allocat-

ing income and expenses and other deductions which are attributable to the unrelated activity so as to clearly reflect unrelated business taxable income.

Congress does not intend that this provision modify the treatment under the regulations of the status of institutes and trade shows. Thus, it is not intended that a tax apply where an industry trade association derives income from trade shows based on charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. This is only true, however, where the show is not a sales facility for individual exhibitors; its purpose must be the promotion and stimulation of interest in, and demand for, the industry's products in general, and it must be conducted in a manner reasonably calculated to achieve that purpose. Also, for the income from the trade show to be free of tax, the stimulation of demand for the industry's products in general must be one of the purposes for which exemption was granted the industry trade association. In such cases, the activities producing the income for the association from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of the association's exempt purpose, and as a result the income is related to its exempt purpose.

Consistent with this policy, the conduct of a trade show by a trade association consisting of members who use the type of products exhibited at the show, or consisting of both this type of member and members who produce or sell the products exhibited, for the purpose of exhibiting and explaining the products, is a related trade or business, provided the show is not used as a sales facility for individual exhibitors.

7. Effective Dates

The provisions relative to the tax on unrelated business income (including the Clay-Brown provision relative to unrelated debt-financed income) are to apply to taxable years beginning after December 31, 1969. However, the Act, in extending the unrelated business income tax to churches provides a period of time (through taxable years beginning before January 1, 1976, before the tax applies, in order to enable churches to dispose of unrelated businesses or to spin them off in separate taxable corporations.

In addition, until taxable years beginning after 1971 the new Clay-Brown rules are to apply only where indebtedness has been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966). The transition period will afford organizations with previously initiated unrelated borrowing an opportunity to prevent or minimize tax under the new rules by disposing of their acquisitions for fair value, by discharging indebtedness in full with exempt income or other assets, or at least by reducing the amount of outstanding indebtedness. After the transition period, the new rules would become applicable to all situations of exempt organization investment borrowing.

C. CHARITABLE CONTRIBUTIONS

1. Fifty-Percent Charitable Contribution Deduction (Sec. 201(a) of the Act and Sec. 170(b) of the Code)

Prior law.—Under prior law, the charitable contributions deduction allowed individuals generally was limited to 30 percent of the taxpayer's adjusted gross income. In the case of gifts to private foundations, however, the deduction was limited to 20 percent of the taxpayer's adjusted gross income. In addition, in limited circumstances, a taxpayer was allowed an unlimited charitable contributions deduction.

General reasons for change.—In order to strengthen the incentive effect of the charitable contributions deduction for taxpayers, the Act generally increases the 30-percent limitation to 50 percent. It is believed that the increase in the limitation will benefit taxpayers who donate substantial portions of their income to charity and for whom the incentive effect of the deduction is strong—primarily taxpayers in the middle- and upper-income ranges. In addition, the combination of the increase in the limitation to 50 percent with the repeal of the unlimited charitable deduction means, in effect, that charity can be an equal partner with respect to an individual's income; however, charitable contributions no longer will be allowed to reduce an individual's tax base by more than one-half.

Explanation of provision.—The Act generally increases the limitation on the charitable contributions deduction for individual taxpayers from 30 percent of adjusted gross income to 50 percent. The 30-percent limitation remains in effect, however, for gifts of appreciated property (see No. 3 below for discussion) unless in computing the amount of the contribution the appreciation element is reduced by one-half. Also, the 20-percent limitation remains for contributions to private foundations which are not operating foundations, unless within 2½ months after the year of receipt they distribute the contributions to an operating foundation or a public charity, school or college, etc., in which event the higher percentage limitations are applicable.

The 50-percent limit is generally not to be available with respect to gifts of property which have appreciated in value. However, where a taxpayer makes a contribution to a public charity of property which has appreciated in value, he may make use of the 50-percent limitation for such contributions if he elects to have these contributions reduced by one-half of the unrealized appreciation in value of the contributed property.

As indicated above, the 20-percent limitation of present law also is removed for contributions to private operating foundations, and for contributions to private nonoperating foundations which distribute the contributions they receive to public charities or private operating foundations within 2½ months following the year of receipt. Gifts to such foundations under the Act are to qualify for the 50-percent limitation (or the 30-percent limitation, as the case may be). The 50-percent (or the 30-percent) limitation is also made available with respect to contributions to private nonoperating foundations which qualify as "community foundations." Community foundations are those which pool the contributions they receive in a common fund but

allow the donor (or his spouse) to retain the right to designate the organization (so long as it is the type qualifying for the 50-percent limitation) to whom the income from the contribution is given and also to whom the corpus of the contribution eventually is given. However, to qualify for this treatment the income must be paid out to "50-percent type charities" by the 15th of the third month after the year in which the income is earned, and the corpus must be distributed to such types of organizations within one year after the death of the donor or his spouse. Contributions to these three categories of private foundations are treated the same as contributions to public charities for purposes of the limitations.

Effective date.—The increase in the limit on the deductibility of contributions from 30 percent to 50 percent (including the change respecting private operating and nonoperating foundations and pooled community funds) is applicable with respect to contributions paid in taxable years beginning after December 31, 1969.

2. Repeal of the Unlimited Charitable Deduction (sec. 201 (a) and (h) of the Act and sec. 170 (b)(1)(C), (f)(6), and (g) of the code)

Prior law.—The charitable contributions deduction for individuals generally was limited to 30 percent of the taxpayer's adjusted gross income. An exception to the 30-percent general limitation allowed a taxpayer an unlimited charitable contributions deduction, if in 8 out of the 10 preceding taxable years, the total of the taxpayer's qualified charitable contributions (under sec. 170(g)(2)) plus income taxes paid exceeded 90 percent of his taxable income.

General reasons for change.—It has been pointed out that the unlimited charitable contributions deduction has permitted a number of high-income persons to pay little or no tax on their income. It appeared that the charitable contributions deduction was one of the two most important itemized deductions used by high-income persons, who paid little or no income tax, to reduce their tax liability.

Explanation of provision.—The unlimited charitable contribution deduction is to be completely eliminated for years beginning after 1974. During the interim period, an increasing limitation is to be placed on the extent to which the so-called unlimited charitable deduction may reduce an individual's taxable income. For taxable years beginning in 1970, this charitable deduction is not to reduce a taxpayer's taxable income to less than 20 percent of his adjusted gross income. This percentage is to be increased ratably by 6 percentage points a year for the years 1971 through 1974, until the limit on the deduction reaches the general 50-percent limit for 1975 and thereafter.

To take account of the increasing limitation on the charitable deduction, the Act also provides that the percentage of the taxpayer's taxable income which must be given to charity (or paid in income taxes) in 8 out of the 10 preceding taxable years in order to qualify for the extra charitable deduction is to be reduced to 80 percent for taxable years beginning in 1970, and is then to be reduced by 6 percentage points a year for subsequent taxable years beginning in 1971 through 1974.

In addition to the above provisions, the Act provides that, during the interim period through 1974, the 30-percent limit on gifts of appreciated property and the appreciated property rule which takes the appreciation into account for tax purposes in the case of property

which would give rise to a long-term capital gain if sold, are not to apply in the case of a person qualifying for the extra charitable contribution deduction (above the general 50-percent limit).

Finally, the Act modifies the eligibility rule for the unlimited charitable deduction so that a taxpayer who remarries (whose former spouse is deceased) and files a separate return is, for purposes of this provision, to be treated as if he had not remarried; that is, the taxpayer is to be able to refer back to his joint tax returns with the deceased spouse for the previous 10 taxable years in determining the eligibility for the extra charitable deduction. It was thought that in such cases it was appropriate to permit a taxpayer to take into account his charitable giving experience before his remarriage since in these cases he is not taking into account the charitable giving of income of the second spouse.

Effective date.—This provision generally is to apply with respect to contributions made in taxable years beginning after December 31, 1969. However, the provision referred to immediately above (where a taxpayer, whose spouse is deceased, remarries) is to be effective for taxable years beginning after December 31, 1968.

3. Charitable Contributions of Appreciated Property (Sec. 201(a) of the Act and Secs. 170(e) and 1011(b) of the Code)

Prior law.—Under prior law, a taxpayer who contributed property which had appreciated in value to charity generally was allowed a charitable contributions deduction for the fair market value of the property, and no tax was imposed on the appreciation in value of the property (nor was the appreciation in value taken into account in any other way for tax purposes). In a few areas, however, a special rule (sec. 170(e)) applied to gifts of certain property. In these cases, the amount of charitable contribution was reduced by the amount of gain which would have been treated as ordinary income under the recapture rules (had the property been sold at its fair market value) for certain mining property (sec. 617(d)(1)), depreciable tangible personal property (sec. 1245(a)), and certain depreciable real property (sec. 1250(a)).

For property sold to a charity at a price below its fair market value—a so-called bargain sale—the proceeds of the sale were considered to be a return of the cost and were not required to be allocated between the cost basis of the “sale” part of the transaction and the “gift” part of the transaction. The seller was allowed a charitable contributions deduction for the difference between the fair market value of the property and the selling price (often at his cost or other basis).

General reasons for change.—The combined effect of not taxing the appreciation in value and at the same time allowing a charitable contributions deduction for the fair market value of the property given produced tax benefits significantly greater than those available with respect to cash contributions. The tax saving resulting from not taxing the appreciation in the case of gifts of long-term capital assets was represented by the amount of the capital gains tax which would have been paid if the asset had been sold. In the case of ordinary income type assets, moreover, this tax saving was at the taxpayer's top marginal tax rate. In addition, the tax saving from not taxing the appreciation in value was combined with the tax saving of the chari-

table deduction at the taxpayer's top marginal rate. As a result, in some cases it was possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds.

In the case of a so-called bargain sale to a charity (often at the taxpayer's cost or other basis), the taxpayer was allowed a charitable deduction for the appreciated value in excess of the sales price to the charity. No tax was payable on any of this excess appreciation, since the taxpayer was not required to allocate his cost or other basis between the part "sold" and the part "given" to the charity. As a result, in cases where the sales price equaled the cost or other basis, the entire appreciation was deductible and no tax was payable on any of the appreciation in value.

Explanation of provision.—The Act provides that the appreciation element in gifts of appreciated property is to be taken into account, or modified, for tax purposes in the case of four types of contributions. In those cases where appreciation is to be taken into account, the charitable deduction for gifts of ordinary income type property (or short-term capital gains property) is to be reduced by the full amount of the appreciation; and in the case of long-term capital gains property, the charitable deduction is to be reduced by 50 percent (62½ percent for corporations) of the appreciation which would have been a long-term capital gain had the property been sold at its fair market value.

(1) *Ordinary income property.*—In the case of gifts of appreciated property which (if sold) would have produced ordinary income or short-term capital gain, the amount of the appreciation in value is to result in a reduction of the contribution deduction to the extent of the appreciation (regardless of the type of charitable organization involved). Examples of the types of property giving rise to ordinary income are gifts of inventory, "section 306 stock" (stock acquired in a nontaxable transaction treated as ordinary income if sold), artistic works and letters, memorandums, etc., produced by the donor, and capital assets held for 6 months or less. The charitable deduction for gifts of property which to some extent at least would produce ordinary income if sold, as a result of the application of various recapture rules (those under secs. 617(d)(1), 1245(a), 1250(a), 1251(c), or 1252(a)), also is to be reduced by the amount subject to the recapture as ordinary income.

(2) *Certain tangible personal property.*—The charitable deduction for gifts of tangible personal property (long-term capital gains property) the use of which is unrelated to the purpose or function constituting the basis for the charitable donee's exemption (under sec. 501 or unrelated to the purpose or function of a governmental unit described in sec. 170(c)) is to be reduced. A clear example of where property is not being used for an organization's exempt purpose is where it is intended at the time of the donation that the exempt organization will sell the property. The amount of the reduction is to be 50 percent (62½ percent in the case of a corporation) of the amount of appreciation which would have been a long-term capital gain if the property contributed had been sold at its fair market value.

(3) *Certain private foundations.*—Appreciation is also to be taken into account for tax purposes in the case of gifts of appreci-

ated property (even though it is property which would produce long-term capital gains if sold) to private foundations unless the foundation is (a) a private operating foundation, (b) a private nonoperating foundation which within 2½ months after the taxable year in which the gift is received distributes an amount equivalent to all contributions received during such taxable year to public charitable organizations or private operating foundations (such amounts distributed must be in addition to the income payout requirement), or (c) a private nonoperating foundation which qualifies as a "community foundation." Contributions to these three categories of private foundations are treated the same as contributions to public charities for purposes of the limitations.

(4) *Bargain sales*.—In the case of so-called bargain sales to charity—where a taxpayer sells property to a charitable organization for less than its fair market value (often at its cost or other basis)—the cost or other basis of the property is to be allocated (for purposes of determining taxable gain to the taxpayer) between the portion of the property "sold" and the portion of the property "given" to the charity, on the ratio of the fair market value of each portion to the total fair market value of the property.

Under cases (1), (2), and (3) above where the charitable contribution made represents less than the taxpayer's entire interest in the property contributed, the taxpayer's adjusted basis in the property is to be allocated between the interest contributed and any interest not contributed according to prescribed regulations.

Effective date.—The amendments made by this provision generally are to apply with respect to contributions paid (or treated as paid under sec. 170(a)(2)) after December 31, 1969; however, in the case of a contribution of a letter, memorandum, or similar property (to which sec. 514 of the Act applies), the amendments apply to such contributions after July 25, 1969. Further, the amendment with respect to bargain sales applies to sales made after December 19, 1969.

4. Repeal of 2-year Charitable Trust Rule (sec. 201(c) of the Act and sec. 673 of the code)

Prior law.—Under prior law, an individual could establish a trust for two years or more with income from the property he transferred to the trust being paid to charity for a period of at least 2 years. After the two years or more, the property was returned to him. In such a case the individual did not receive a charitable contributions deduction, but the income from the trust property was not taxed to him. This 2-year charitable trust rule was an exception to the general rule to the effect that the income of a trust is taxable to a person who establishes the trust where he has a reversionary interest in the trust which will (or may be expected to) take effect within 10 years.

General reasons for change.—The effect of the special 2-year charitable trust rule was to permit charitable contributions deductions in excess of the generally applicable percentage limitations of such deductions. For example, with the 50-percent limitation on charitable deductions, the maximum deductible contribution that could be made each year by an individual with \$100,000 of dividend income (but no other income) would be \$50,000. However, if the individual transferred

70 percent of his stock to a charitable trust with directions to pay the annual income (\$70,000) for two years to charity and thereafter to return the property to him, the taxpayer under prior law would have been able to exclude the \$70,000 from his income each year. The result is the same as if the taxpayer had a 70-percent charitable contributions deduction each year. The Congress believed that taxpayers should not be allowed to avoid the limitations on the charitable contribution deduction by using a 2-year charitable trust.

Explanation of provision.—To overcome the result described above, the Act repeals the 2-year charitable trust provision (sec. 673(b)). As a result, a person who establishes a trust will be taxable on its income, whether or not the income beneficiary is a charity, where the individual has a reversionary interest which will (or may be expected to) take effect within 10 years from the time the income-producing property is transferred to the trust.

Effective date.—This provision is to apply with respect to transfers in trust made after April 22, 1969.

5. Gifts of the Use of Property (sec. 201(a) of the Act and sec. 170(f) (3) and (4) of the code)

Prior law.—Under prior law, there was some authority to the effect that a taxpayer could claim a charitable deduction for the fair-rental value of property which he owned and gave to a charity to use for a specified period of time. In addition, he could exclude from his income the income which he would have received and been required to include in his tax base had the property been rented to other parties.

General reasons for change.—The treatment accorded under prior law presumably enabled taxpayers to obtain what may be described as a double tax benefit where they gave charities the right to use property which they owned for a given period of time. For example, if the individual owned an office building, he could donate the use of 10 percent of its rental space to a charity for 1 year. As a result, under prior law he apparently could report for tax purposes only 90 percent of the income which he otherwise would have had (if the building were fully rented), and could also claim a charitable deduction (amounting to 10 percent of the rental value of the building) which would have offset his already reduced rental income.

Explanation of provision.—The Act generally provides that a charitable deduction is not to be allowed for contributions to charity of less than the taxpayer's entire interest in property, except to the extent a deduction would have been allowed had the interest been transferred in trust. Moreover, no deduction is to be allowed where a contribution is made of the right to use property for a period of time. In such a case, however, the taxpayer is able to continue to exclude from his income the value of the right to use the property contributed to the charity.

The Act does not deny a deduction, however, where an outright gift is made of an undivided (e.g., one-fourth) interest in property. In this regard, a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity.

In addition, the Act does not deny a deduction for a contribution of a remainder interest in a personal residence or farm. However, in determining the value of the remainder interest, depreciation (com-

puted on the straight line method) and depletion of the property (computed on a cost basis) will be taken into account, and the value of the remainder will be discounted at a rate of 6 percent given current money rates (but the Secretary of the Treasury may prescribe a different rate as general money rates change).

Effective date.—These amendments apply to gifts made after July 31, 1969.

6. Charitable Contributions by Estates and Trusts (sec. 201(b) of the Act and sec. 642(c) of the code)

Prior law.—Under prior law, a nonexempt trust (or estate) was allowed a full deduction for any amount of its gross income which it paid or which it permanently set aside for charitable purposes. There was no limitation on the amount of this deduction.

General reasons for change.—The Congress concluded that it would be inconsistent to retain the deduction allowed by prior law for nonexempt trusts for amounts set aside for charity (rather than paid to charity) if at the same time foundations and charitable trusts were to be required to distribute all of their income currently. Not to subject these trusts generally to the same requirements and restrictions as those imposed on private foundations would present an easy means of avoiding these restrictions by setting amounts aside for charity in nonexempt trusts but not distributing these amounts for extended periods of time.

In the case of estates, however, it was believed not appropriate to eliminate the set-aside deduction since there are safeguards in the case of estate administration not usually present during trust administration, and, in addition, it is often impractical, and often contrary to probate law, for an estate to make current distributions to charity.

In the case of long-term capital gain income, the set-aside deduction was also continued for pooled income arrangements. Under these arrangements a person transfers property to a public charity which then places the property in an investment pool and pays the donor (and, perhaps, another person) the income attributable to the property for life. Capital gains in these cases are normally allocable to the charity but income earned on these gains for the lives of the donors customarily belongs to the donors. This makes it impossible in these cases to pay out the capital gains when realized and still carry out the intent of the arrangement. Pooled income arrangements have been increasingly relied upon by public charities as a means of obtaining charitable contributions. It was feared that the complete removal of the set-aside deduction in their case would have a serious adverse effect on charitable giving to these public institutions.

Explanation of provision.—In general, the Act eliminates the so-called set-aside deduction previously allowed trusts. (The Act does not affect the set-aside deduction allowed estates.) However, a nonexempt trust will still be allowed in computing its taxable income to deduct any amount of its gross income, without limitation, paid out as a charitable contribution. In addition, to enable the trustee to act after he knows the income for the year precisely, a trustee may make a contribution in the next following taxable year and elect to treat such contribution as made during the taxable year. As under prior law, an adjustment is made for charitable contributions paid out of capital gain income so that the capital gains and charitable deductions are not

allowed with respect to the same amount. Also, as under prior law, the deduction for the amount paid out may not diminish any unrelated business income of the trust. These rules of prior law also are applicable in cases where the set-aside deduction continues to be available.

In the case of pooled income funds, the Act provides that the fund may deduct amounts set aside for charitable purposes to the extent of the fund's long-term capital-gain income. Generally, a pooled income fund is a trust to which a person has transferred property giving an irrevocable remainder interest in the property to a public charity and retaining an income interest in the property for the life of one or more beneficiaries living at the time of the transfer. The fund must commingle the property transferred to it with property transferred to it under similar circumstances by other persons. It is further provided that the fund may have no investments in tax-exempt securities, that no donor or income beneficiary may be a trustee of the fund, and that the fund must be maintained by the charitable organization to which the remainder interest is given. It is not necessary, however, for the charitable organization to be the trustee of the fund. Each person who has a life income interest as a result of a transfer of property to the pooled income fund must receive an amount of income for each year which is determined with reference to the trust's rate of return for the year. A pooled income fund will not qualify under this provision if it includes amounts received under types of arrangements other than those described above. A pooled income fund, however, may be commingled with other assets for investment purposes if there is a separate accounting for the fund's assets.

The set-aside deduction is continued in the case of existing arrangements which were previously established in contemplation that the set-aside deduction would continue to be available and which cannot be modified to take the new rules into account. More specifically, the Act provides that the set-aside deduction continues to be available for a trust established before October 10, 1969, which is required by the terms of its governing instrument to set-aside amounts, either if an irrevocable remainder interest in the trust was given to charity or if the trust could not be modified at any time after October 9, 1969, because the grantor was under a mental disability to change its terms at all times after that date. The set-aside deduction continues to be available in these cases, however, only if the governing instrument of the trust requires it to set aside amounts and only to the extent of income earned on amounts transferred to the trust prior to October 9, 1969.

The set-aside deduction also continues to be available in the case of a trust established by a will in existence on October 9, 1969, which the testator could not modify prior to his death either because he was under a mental disability on that date and at all times thereafter or because he did not have the right at any time after that date to change the will as it relates to the trust.

In order to allow a reasonable time for amendment of existing wills which provide for a trust that is to set aside amounts for charity, to take the unavailability of the set-aside deduction provided by the Act into account, the Act also provides that the set-aside deduction continues to be available in the case of trusts established by a will in existence on October 9, 1969, if the testator dies within 3 years (i.e., before October 9, 1972) without having republished the will. The

set-aside deduction continues to be available in these cases, however, only if the governing instrument of the trust requires it to set aside amounts and only to the extent of income earned by the trust on amounts transferred to it under the will establishing it.

Effective date.—The changes made by this provision apply, except as discussed above, to amounts paid or set aside in taxable years beginning after December 31, 1969.

7. Charitable Remainder Trusts (sec. 201(a), (d), and (e) of the Act and secs. 170(f), 664, 2055(e), 2106(a), and 2522(c) of the code)

Prior law.—Under prior law, an individual could make an indirect charitable contribution by transferring property to a trust and providing that the income was to be paid to private persons for a period of time with the remainder to go to a charity. A charitable contributions deduction generally was available for the remainder interest given to charity. The amount of the deduction was based on the present value of the remainder interest which was determined by using actuarial life expectancy tables and an assumed interest rate.

Under prior regulations, the assumed interest rate was 3½ percent. In other words, it was assumed that there would be a 3½ percent income return on trust assets and also the 3½ percent rate was used to determine the present value of the income and remainder interests.

General reasons for change.—The rules of the prior regulations had the effect of allowing a taxpayer to receive a charitable contribution deduction for a gift to charity of a remainder interest in trust which was substantially in excess of the amount the charity might ultimately receive. This was because the assumptions used in calculating the value of the remainder interest bore little relation to the actual investment policies of the trust. For example, the trust assets could have been invested in high-income, high-risk assets. This enhanced the value of the income interest but decreased the value of the charity's remainder interest. This factor, however, was not taken into account in computing the amount of the charitable contribution deduction.

Congress' attention also was called to the fact that in some cases charitable contribution deductions have been allowed for gifts of charitable remainder interests in trust even though it was likely that the gift would not ultimately be received by the charity. An example of this was a situation where the charity had only a contingent remainder interest in the trust (for example, a \$5,000 annuity to A for life, remainder to his children, or to a charity if A had no children). Another example was the situation where a charity had a remainder interest and the trust permitted invasion of the charitable share for the benefit of a noncharitable intervening interest which was incapable of reasonably certain actuarial valuation (for example, a \$5,000 annuity to A for life, remainder to a charity, but the trust provided that the trustee may pay A amounts in excess of \$5,000 in order to maintain his standard of living).

It is the understanding of Congress that a charitable contribution deduction for income tax purposes would not be allowed in these situations if the probability of the charity receiving the specified interest were determined under the rules previously applied in the case of the estate tax. It is the intent of Congress that uncertain invasions of corpus should not be possible if an income tax deduction is to be allowed.

Explanation of provision.—For the reasons discussed above, the Act provides limitations (for income tax, gift tax, and estate tax purposes) on the allowance of a charitable contributions deduction for a charitable gift of a remainder interest. In general, a deduction is allowed for a charitable gift of a remainder interest in trust, where there is a noncharitable income beneficiary, if the trust is either a charitable remainder annuity trust or a charitable remainder unitrust. These general limitations are provided so the amount received by the charity will be consistent with the charitable deduction allowed to the donor on creation of the trust. This result occurs under these two limitations because they remove the flexibility of the prior provisions whereby it was possible to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments. Under the new requirements, the amount received each year by the income beneficiary, generally, will have to be either a stated dollar amount or a fixed percentage of the value of the trust property.

An exception to the two general rules is provided, however, for a gift of a charitable remainder interest in trust which takes the form of a transfer of property to a pooled income fund. (The definition of a pooled income fund is discussed in No. 6 above.) In order to prevent manipulation designed to overstate the appropriate charitable contributions deduction in the case of this type of gift, it is provided that the amount of the charitable contribution deduction allowed the donor upon the transfer of property to the pooled income fund is to be determined by valuing the income interest on the basis of the highest rate of return earned by the particular pooled income fund in any of the three taxable years preceding the taxable year of the fund in which the transfer occurs. Where a fund has not been in existence for this period of time, the rate of return is assumed to be 6 percent, unless a different rate is prescribed by the Secretary of the Treasury or his delegate.

A second exception to the two general limitations is provided in the case of a gift of a remainder interest, not in trust, of a personal residence or a farm. Thus, for example, a charitable contribution deduction is allowed where an individual makes a gift of his residence to charity and retains the right to live in the residence for his life. Congress did not believe that this type of situation presented the kind of abuse which it was appropriate to curtail.

In determining the value of a remainder interest in real property which is given to charity, straight-line depreciation and cost depletion are taken into account. Thus, in the value of the charitable gift, there will be a decrease in the value of the property which reflects the depreciation or depletion of the property. In addition, in valuing this type of charitable gift, the present value of the gift is determined on the basis of a 6 percent interest rate. This rate may be changed by the Treasury Department as interest rates and investment returns change.

The annuity trust referred to in the general rules above is one which specifies in dollar terms the amount of the annuity which is to be paid to the income beneficiary. The trust also must require the income payments to be made at least annually. The unitrust referred to in the general rules is a trust which specifies that the income beneficiary is to receive annual payments based on a fixed percentage of the fair market value of the trust's assets, as determined each year. The income

interest in either case may either be for a term of years or for the life of the income beneficiary.

The Act follows these general definitions with the following modifications. First, it allows a charitable remainder unitrust to provide that when the trust income is less than the required payment to the non-charitable income beneficiary, the trust need only distribute to the income beneficiary the amount of the trust income. The deficiencies in income distributions in this case (i.e., where the trust income was less than the stated amount payable to the income beneficiary) must be made up in later years when the trust income exceeds the amount otherwise payable to the income beneficiary for that year. The determination of what constitutes trust income under this provision is made under the applicable local law and, thus, does not include items such as capital gains which must be allocated to the trust principal.

A second modification of the general annuity trust and unitrust rules made by the Act provides that a charitable remainder trust must be required by the trust instrument to distribute each year 5 percent of the net fair market value of its assets (valued annually in the case of a unitrust and valued at the time of the contribution in the case of an annuity trust) or in the case of a unitrust the amount of the trust income, whichever is lower. In valuing the amount of a charitable contributions deduction in the case of a remainder interest given to charity in the form of an annuity trust or a unitrust, the deduction is computed on the basis that the income beneficiary of the trust will receive each year the higher of 5 percent of the fair market value of the trust assets or the payment provided for in the trust instrument. In addition, the Act provides that an annuity trust or unitrust may not provide for payments to the noncharitable income beneficiaries of amounts other than the stated annuity or fixed percentage amount.

The modifications of the general annuity trust and unitrust rules will allow greater flexibility in the making of charitable gifts in the form of remainder interests in trust but at the same time will adequately protect against abuse. Allowing a charitable remainder unitrust to distribute to the income beneficiary the lesser of the trust income or the stated payout will prevent a trust from having to invade its corpus when the income for a year is below that originally contemplated.

On the other hand, requiring a charitable remainder unitrust to distribute currently at least the amount of its income (other than long-term capital gains), if this is less than a 5 percent payout and the requirement that the charitable remainder interest be valued by assuming at least a 5 percent payout to the income beneficiary will prevent a charitable remainder unitrust from being used to circumvent the current income distribution requirement imposed on private foundations. In the absence of these rules, a charitable remainder unitrust could be established which provided for a minimal payout to the noncharitable income beneficiary (substantially less than the amount of the trust income). Since the trust generally is exempt from income taxes this would allow it to accumulate trust income in excess of the general payout requirement without tax for the future benefit of charity.

An annuity trust or a unitrust under the provisions enacted may have more than one noncharitable income beneficiary, if the interest

of each such beneficiary either is for a term of years which does not exceed 20 years or is for the life of the beneficiary. An individual who is not living at the time of creation of the trust, however, may not be an income beneficiary of a charitable remainder trust.

Under either an annuity trust or a unitrust, an amount paid to the income beneficiary is treated as consisting of the following amounts: First, ordinary income to the extent of the trust's ordinary income for the taxable year and its undistributed ordinary income from prior years; second, as a capital gain to the extent of the trust's capital gains for the taxable year and its undistributed capital gains (determined on a cumulative net basis) for prior years; third, as other income (such as non-taxable income) to the extent of the trust's other income for the year and its undistributed other income from prior years; and finally, as a distribution of corpus.

A charitable remainder trust which qualifies as an annuity trust or a unitrust is exempt from income taxation, except that this exemption from tax is denied for any year in which the trust has income which would be unrelated business taxable income if the trust were an exempt organization subject to the unrelated business income tax. This prevents the avoidance of the unrelated business income tax by the use of a charitable remainder trust rather than a tax-exempt organization.

Effective date.—This provision is effective with respect to transfers in trust and contributions after July 31, 1969, for income tax purposes, and with respect to gifts made after July 31, 1969, for gift tax purposes.

In the case of the estate tax, this provision generally applies with respect to decedents dying after December 31, 1969.

Exceptions were provided, however, for existing arrangements which were established under prior law and which cannot be modified to take the new rules into account. Accordingly, the new rules do not apply for estate tax purposes in the case of property transferred in trust before October 10, 1969, in which an irrevocable remainder interest was given to charity. In addition, the new rules do not apply in the case of property passing under a will in existence on October 9, 1969, or property transferred in trust on or before that date, if the will or trust was not modified by the individual prior to October 9, 1972, and could not be modified thereafter by the decedent because he was under a mental disability on that date and at all times thereafter. It also is provided that the new rules do not apply to property passing under a will in existence on October 9, 1969, where the individual did not have at any time thereafter the right to change the will as it relates to the charitable gift.

A reasonable period of time also is provided for existing wills and existing trusts to be modified to take the new rules into account. Accordingly, it is provided that the new rules do not apply to property passing under a will in existence on October 9, 1969, or to property transferred in trust on or before October 9, 1969, if the individual dies within three years (i.e., before October 9, 1972) without having modified the will or trust.

8. Charitable Income Trust with Noncharitable Remainder (sec. 201(a) and (d) of the Act and secs. 170(f), 2055(e), 2106(a), and 2522(c) of the code)

Prior law.—Under prior law, a taxpayer who transferred property to a trust to pay the income to a charity for a period of years with the remainder to go to a noncharitable beneficiary, such as a friend or member of his family, was allowed a charitable contribution deduction for the present value of the income interest given to the charity. In addition, generally, neither he nor the trust was taxed on the income earned by the trust.

The charitable contribution deduction referred to above was not allowed, however, for a gift of an income interest in trust to a charity where the grantor retained a substantial (over 5 percent) reversionary interest in the trust. In addition, a grantor who retained a reversionary interest in a trust was taxed on the income earned by the trust with respect to the property which was to revert to him if his reversionary interest could be reasonably expected to take effect within 10 years (or 2 years if the 2 year charitable trust rule repealed by the Act applied) from the time of the transfer to the trust.

General reasons for change.—The Congress concluded that it was undesirable to permit a taxpayer to receive a double tax benefit by allowing him a charitable deduction for the value of an income interest in trust given to charity and at the same time not taxing him on the income earned by the trust. The Congress was also concerned because the charitable contribution in many cases was being overvalued.

Explanation of provision.—The Act dealt with the problems described above first by providing that for income tax purposes a charitable contribution deduction is not allowed for an income interest given to charity in trust, unless the grantor is taxable on the income of the trust or unless all the interests in the trust are given to charity. The Act provides that a charitable deduction in no event is allowed for income tax purposes for an income interest given to charity in trust unless the interest is in either an annuity or a unitrust format (i.e., where the charitable income beneficiary is to receive a fixed amount each year or a fixed percentage annually of the fair market value of the trust property).

Since the grantor is now denied an exclusion for gifts of income to charity where the property is likely to revert to him within 10 years, the charitable contribution deduction is made available in such cases (where requirements set forth below are met). However, as indicated above, the charitable contribution deduction no longer is available under the Act in those cases where the grantor is not taxed on the income because the remainder in the property goes to someone else. Thus, the deduction is available in the first case, and the exclusion in the second. In no event, however, are both available with respect to the same income interest.

The purpose of the unitrust-annuity trust requirement, in those cases where a charitable contribution deduction may be available, is to assure that the amount received by the charity bears a reasonable correlation to the amount of the charitable contribution deduction allowed the taxpayer.

The requirement that the grantor be taxable on the income of the trust is not applicable for estate and gift tax purposes since in the case of these taxes there is no possibility of a double allowance. However, the unitrust-annuity trust requirement is applicable in determining whether the income interest qualifies as an estate or gift tax charitable contribution deduction.

The Act provides a special rule where under the rules set forth above the taxpayer is allowed a charitable deduction for income tax purposes for an income interest transferred in trust to charity but subsequently for any reason ceases to be taxable on the trust income. In this case under the general rule, the grantor would receive a double tax benefit with respect to the future trust income—he would not be taxed on that income but would have received a charitable deduction with respect to it. To prevent this result, the Act provides for the recapture of that part of the charitable contribution deduction previously received by the taxpayer with respect to the income of the trust which will go to the charity but on which he will not be taxed. This is accomplished by treating the donor at the time he ceases to be taxable on the trust income as having received income to the extent the deduction he previously was allowed exceeds the value of the income previously earned by the trust and taxable to him. For this purpose, these amounts of income are discounted to their value at the time of the contribution to the trust.

Effective date.—This provision applies for income and gift tax purposes with respect to transfers of property to a trust after July 31, 1969. For estate tax purposes, the effective dates of this provision are the same as those discussed in No. 7 above.

9. Limitations on Nonexempt Trusts (sec. 101 of the Act and secs. 508 and 4947 of the code)

Prior law.—Prior law did not impose restrictions or requirements on nonexempt trusts similar to those imposed by the Act on private foundations. In addition, the allowability of a charitable contributions deduction (for income, gift, and estate tax purposes) for a gift to charity in the form of an interest in trust was not conditioned on the existence of provisions in the trust instrument which prevent the trust from violating restrictions or requirements of this nature.

General reasons for change.—If a nonexempt charitable trust were not subject to many of the requirements and restrictions imposed on private foundations, it would be possible for taxpayers to avoid these restrictions by the use of nonexempt trusts instead of private foundations.

Explanation of provision.—The Act prevents the avoidance of the foundation rules by providing generally that nonexempt charitable trusts are subject to most of the same requirements and restrictions as are imposed on private foundations. The restrictions made applicable are those relating to termination of private foundation status, governing instruments, self-dealing, retention of excess business holdings, and the making of speculative investments or taxable expenditures. However, the current income payout requirement and the excise tax based on investment income are made applicable only where all of the interests in the trust are charitable. In addition, the stock ownership and speculative investment requirements imposed on private foundations apply to charitable trusts but do not apply to

split-interest trusts (i.e., trusts which have a noncharitable income beneficiary and a charitable remainder beneficiary or vice versa) (A) in cases where charity is only an income beneficiary and the beneficial interest of charity in the trust is less than 60 percent of the value of the trust property and also (B) in cases where the only interest of charity in the trust is as a remainderman. In the latter case, the stock ownership and speculative investment requirements become applicable at the time the remainder interest of charity comes into possession.

The Act also provides that a charitable contribution deduction (for income, gift, and estate tax purposes) is not allowed for a contribution of a charitable interest in a nonexempt trust unless the trust instrument prohibits the trust from violating the restrictions and requirements to which it is subject (such as self-dealing, business holdings, etc.).

Effective date.—The imposition on nonexempt charitable trusts of the requirements and restrictions imposed on private foundations takes effect as of January 1, 1970. In the case of split interest trusts, however, these rules apply only with respect to amounts transferred in trust on or after May 27, 1969.

The rules relating to the allowance of a charitable contributions deduction for contributions to nonexempt charitable trusts generally are applicable as of January 1, 1970. In the case of trusts created before January 1, 1970, however, these rules apply only with respect to contributions to the trust in years beginning after December 31, 1971.

10. Revenue effect

The net revenue increase under the charitable contributions deduction provisions of the Act is estimated at \$5 million in 1970 and \$20 million in 1972 and thereafter.

D. FARM LOSSES

1. Gain from Disposition of Property Used in Farming where Farm Losses Offset Nonfarm Income—Excess Deductions Account (sec. 211 of the Act and sec. 1251 of the Code).

Prior law.—Under existing law, income or losses from farming may be computed under more liberal accounting rules than those generally applicable to other types of business activities. In general, where a significant factor in a business is the production or sale of merchandise, the taxpayer must use an accrual method of accounting and inventories. The effect of these accounting rules is to postpone the deduction of the costs of the merchandise until the accounting period in which the income from its sale is realized. These rules need not be followed, however, with respect to income or deductions from farming. In other words, a cash accounting method may be used for this purpose under which costs are deducted as incurred. A taxpayer in the business of farming is also allowed to deduct expenditures for developing a business asset which other taxpayers would have to capitalize.

For instance, the expenses of raising a breeding herd of livestock may be currently deducted. The same is true of expenditures to develop a fruit orchard. There also are certain other capital expendi-

tures in connection with farming operations which a taxpayer may elect to currently deduct from ordinary income. The capital expenditures which qualify for this treatment are soil and water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenditures (sec. 182). Under normal business accounting rules, these expenditures would be added to the basis of the farm property and, thus, would reduce the amount of capital gain realized when the property is sold. However, by allowing these expenses to be currently deducted, they reduce ordinary income rather than capital gain income.

Prior law also provided that livestock held for draft, breeding, or dairy purposes for 12 months or more was eligible for capital gains treatment on its sale. Other livestock held for use in a trade or business (such as horses held for the purpose of racing) under rules generally applicable also could be eligible for capital gains treatment upon sale. The same is true of orchards held for the production of fruit crops.

General reasons for change.—Although the special farm accounting rules were adopted to relieve farmers of bookkeeping burdens, these rules were used by some high-income taxpayers who were not primarily engaged in farming to obtain a tax, but not an economic, loss which was then deducted from their high-bracket, nonfarm income. In addition, when these high-income taxpayers sold their farm investment, they often received capital gains treatment on the sale. The combination of the current deduction against ordinary income for farm expenses of a capital nature and the capital gains treatment available on the sale of farm assets produced significant tax advantages and tax savings for these high-income taxpayers.

Explanation of provision.—In general, the Act provides for the recapture of the farm losses previously used by a taxpayer to offset nonfarm income to the extent such losses are required to be added to the excess deductions account (explained below). The recapture occurs upon the sale or other disposition of farm property, but does not affect the current deductibility of farm losses. In addition, it does not apply to taxpayers who use an accrual method of accounting and who elect to compute their farm income by capitalizing those farming expenses which may either be deducted or capitalized.

Taxpayers with losses from farming operations must establish and maintain excess deductions accounts. The amount of any farm net loss of a taxpayer for a taxable year is determined and added to the excess deductions account. In the case of individuals and estates, farm losses must be added to the taxpayer's excess deductions account for the taxable year only if the taxpayer has more than \$50,000 of nonfarm adjusted gross income for the year and only to the extent the taxpayer's net farm loss for the year exceeds \$25,000.¹ The dollar limitations also apply to a subchapter S corporation if no individual who is a shareholder of the corporation has a net farm loss.²

If a taxpayer with a balance in his excess deductions account has net farm income (ordinary income) for a taxable year, the amount in the account is reduced by the amount of that net farm income. This offset is provided since it is an indication that there was ordinary farm

¹ These dollar amounts are cut in half (to \$25,000 and \$12,500, respectively) in the case of a married taxpayer who files a separate return unless the taxpayer's spouse does not have any nonfarm adjusted gross income for the taxable year.

² The period for making this determination is the shareholder's taxable year with which or within which the taxable year of the corporation ends.

income against which the deductions could have been taken and that, in effect, there was no offset of ordinary nonfarm income with farm deductions.

The balance in a taxpayer's excess deduction account also is reduced to the extent necessary to reflect the fact that it contained a farm loss (either with respect to the taxable year or a prior year) which had not, in fact, been used to reduce the taxpayer's tax liability. (For example, where the taxpayer's farm losses had not been entirely offset against nonfarm income because the farm losses in excess of \$25,000 exceeded nonfarm income.)

The purpose of the excess deductions account is to provide a measure of the amount of capital gains arising on the sale or disposition of farm property which is treated as ordinary income rather than as capital gains because of the offset of nonfarm income (over \$25,000 in the case of individuals and estates) with farm deductions. Accordingly, gains arising during the taxable year on the sale or other disposition of farm property are treated as ordinary income rather than as a capital gain only to the extent of the balance in the excess deductions account.

In the case of a sale or exchange of land which is farm property, an additional limitation is placed on the amount of the gain which is treated as ordinary income. Under this limitation, the amount recaptured from the excess deductions account may not exceed the deductions allowed to the taxpayer with respect to the land for soil and water conservation expenditures (sec. 175) and land-clearing expenditures (sec. 182) in the current year and the 4 previous years.

When a capital gain from the sale of farm property is treated as ordinary income under the rules just described, this amount is subtracted from the excess deductions account. In other words, the excess deductions account is reduced by farm losses recaptured.

The farm property which may result in a recapture of farm losses when sold or disposed of is, in general, property used in the trade or business of farming by the taxpayer.³ For this purpose, farm property does not include depreciable real property such as buildings, barns, and so forth. Accordingly, the sale of this type of property does not give rise to a recapture under this provision.

The amount to be added to a taxpayer's excess deductions account in any year is determined with reference to the amount of the taxpayer's farm loss for the year. This consists of all deductions which are directly connected with the farming business to the extent they exceed the income from the business.⁴

The Act provides that the farming business of a taxpayer engaged in the raising of horses also includes the racing of horses. In addition, it is provided that the farming businesses of a taxpayer who is engaged in more than one farming operation are aggregated and treated as one business.

A taxpayer is not required to add his farm losses to an excess deductions account if he elects to compute his farm income by using inventories and by capitalizing those farming expenditures which may either be deducted or capitalized. In the case of a taxpayer who

³ More precisely property described in section 1231(b): i.e., depreciable business property held for more than 6 months, business real property held for more than 6 months, livestock, and unharvested crops.

⁴ For this purpose, section 1231(a) losses or gains on farm property are not taken into account. In other words, section 1231(a) losses on farm property do not increase the amount of a farm loss and section 1231(a) gains on farm property do not reduce a farm loss.

makes this election and uses an accrual method of accounting in which inventories are valued on the unit livestock method, it is contemplated that the unit livestock valuation will be changed from time to time and from area to area to reflect the actual costs of raising livestock.⁵

A series of exceptions to the recapture rules are provided to cover situations involving gifts, transfers at death, certain corporate liquidations, organizations or reorganizations,⁶ like-kind exchanges, and involuntary conversions. The Act also provides for the transfer of a taxpayer's excess deductions account in the case of certain corporate liquidations or reorganizations⁷ as well as in situations where a taxpayer gives away a significant portion of his farm property with respect to which there is a potential recapture. The rule in the case of property given away applies where the unrealized gain (fair market value less the taxpayer's adjusted basis) on the farm property given away during a 1-year period represents more than 25 percent of the unrealized gain on the farm property held by him at the beginning of the period.

The Act also provides that a partner is to take into account his distributive share of the partnership's farm losses, gains from dispositions of farm business property, etc.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

2. Depreciation Recapture (sec. 212(a) of the Act and sec. 1245(a) of the code)

Prior law.—Under existing law, when a taxpayer sells personal property which he has used in a business, there is a recapture of the depreciation he claimed on the property (to the extent of the gain realized on the sale). In other words, the gain on the sale of the property is not treated as a capital gain, but rather is ordinary income to the extent of the depreciation deductions claimed by the taxpayer in prior years. These recapture rules did not apply, however, under prior law in the case of livestock.

General reasons for change.—The exclusion of livestock from the depreciation recapture rule under prior law had the effect of allowing a taxpayer to convert ordinary income into capital gain with substantial tax savings. This occurred because the depreciation was deducted currently from ordinary income taxed at the regular rates, but the gain on the sale of the livestock was taxed only at the lower capital gains rates.

Explanation of provision.—In order to place livestock in the same position as other types of business property, the Act eliminates the exception for livestock from the depreciation recapture rules. Thus, the gain on the sale or other disposition of purchased livestock with respect to which depreciation deductions have been claimed is treated as ordinary income rather than as capital gain, to the extent of the depreciation deductions previously claimed, in the same manner as

⁵ A taxpayer who elects to follow proper accounting rules, so as not to be required to maintain an excess deductions account, will be treated (if the election requires him to change his method of accounting with respect to the farming business) as having made the change with the consent of the Secretary of the Treasury or his delegate. In addition, such a change will be treated as not having been initiated by the taxpayer for purposes of the rule which precludes adjustments resulting from changes in the taxpayer's method of accounting with respect to any pre-1954 Code year.

⁶ The corporation liquidations, organizations, and reorganizations covered are those in which the transferee has a carryover basis for transferred property by reason of section 332, 351, 361, 371(a), or 374(a).

⁷ The corporate liquidations and reorganizations covered are those described in footnote 6 to which section 371(a), 374(a) or 381 is applicable.

if any other type of tangible personal property used in a business were sold.

Effective date.—This provision is effective with respect to taxable years beginning after December 31, 1969. The recapture rule, however, applies only to the extent of depreciation deductions for periods after December 31, 1969.

3. Holding Period for Livestock (sec. 212(b) of the Act and sec. 1231(b) of the code)

Prior law.—Under prior law, gain from the sale of livestock held for draft, breeding, or dairy purposes qualified for capital gain treatment if the animal had been held by the taxpayer for 1 year or more.

General reasons for change.—A one-year holding period allowed taxpayers to make short-term, tax-motivated investments in livestock. For example, a taxpayer could go into the livestock business to build up a breeding herd over a short period of time, currently deduct the expenses of raising the animals against his other income which was taxed in the high bracket, and then sell the entire herd at the lower capital gains rates.

Explanation of provision.—The Act extends the present one-year holding period for cattle and horses, which are held for draft, breeding, dairy or sporting purposes, to two years. Thus, cattle and horses do not qualify for long-term capital gains treatment unless held by the taxpayer for at least two years for one of the specified purposes. The present one-year holding period for other types of livestock is not changed by the Act, other than to include animals held for sporting purposes within the scope of this rule.

The Congress believes that the mere satisfaction of the holding period requirement in the case of livestock should not, in itself, be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). Thus, even though a taxpayer holds livestock for the necessary period, he should not, merely because of that fact, be treated as having held the animal for one of the specified purposes. This determination should be made on the basis of all the facts and circumstances which indicate the purpose for which the animal was held.

Effective date.—This provision is effective with respect to livestock acquired after December 31, 1969.

4. Exchange of Livestock of Different Sexes (sec. 212(c) of the Act and sec. 1031 of the code)

Prior law.—Existing law provides that property held for productive use in a trade or business or held for investment may be exchanged tax-free for property of a like-kind.

General reasons for change.—There appeared to be some confusion prior to the Act as to whether an exchange of male calves for female calves qualified as a tax-free, like-kind exchange. This would permit a breeding herd of females to be built up more quickly without tax consequences. Although the Revenue Service does not consider this to be a like-kind exchange, it did not take a published position.

Congress does not believe that this type of exchange should be considered as a like-kind exchange. It also believes that allowing this treatment would be an incorrect interpretation of the existing statute.

Explanation of provision.—The Act provides that, for purposes of applying the tax-free, like-kind exchange rule of existing law, livestock of different sexes is not property of a like-kind.

Effective date.—Since this provision is merely declaratory of what Congress intended in the law prior to the Act, it applies with respect to taxable years to which the Internal Revenue Code of 1954 applies.

5. Hobby Losses (sec. 213 of the Act and secs. 183 and 270 of the code)

Prior law.—Prior law contained a so-called “hobby loss” provision (section 270) which limited to \$50,000 per year the amount of losses from a trade or business carried on by an individual that could be used to offset other income. This limitation only applied, however, where the losses from the business exceeded \$50,000 per year for a period of at least 5 consecutive years. In computing the amount of a loss for purposes of this provision, certain specially treated deductions were disregarded. These disregarded deductions were taxes, interest, casualty and abandonment losses connected with a trade or business, farm drought losses, net operating loss carryovers, and expenditures which may either be capitalized or currently deducted.

General reasons for change.—The hobby loss provision generally was of limited application because it usually was possible to break the required string of five loss years. In addition, where the provision applied to disallow the deduction of a loss, the taxpayer was faced in one year with a combined additional tax attributable to a five-year period.

Explanation of provision.—The Act provides in general that an individual (or a subchapter S corporation) is not allowed to deduct losses (to the extent attributable to business deductions) arising from an activity which is not engaged in for profit. This rule does not apply to corporate taxpayers (other than subchapter S corporations). No inference should be drawn from the inapplicability of this rule in the case of a corporation, however, as to whether or not any activity of the corporation is a business, or is engaged in for profit, for purposes of the tax laws.

An activity is not engaged in for profit if deductions with respect to the activity are not allowable as trade or business expenses or as expenses incurred for the production of income or in connection with property held for the production of income. In making the determination of whether an activity is not engaged in for profit, it is intended that an objective rather than a subjective approach be employed. Thus, although a reasonable expectation of profit is not required, the facts and circumstances (without regard to the taxpayer’s subjective intent) have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit. A taxpayer who engaged in an activity in which there was a small chance of a large profit, for example, a person who invested in a wild-cat oil well or an inventor, could qualify under this test even though the expectation of profit might be considered unreasonable.

Even where an activity is not engaged in for profit, however, the Act specifically provides that a deduction is allowed for items which are of the type which may be deducted without regard to whether they are incurred in a trade or business or for the production of income. This would include the deductions allowed for interest and state and local property taxes, and the long-term capital gains deduc-

tion. It further provides that, in the case of an activity not engaged in for profit, a deduction is nevertheless allowed for the trade or business or production of income items which could be deducted if the activity were engaged in for profit, but only to the extent these items do not exceed the amount of gross income derived from the activity reduced by the deductions which are allowed in any event such as interest and certain state and local taxes.

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

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

6. Gain From Disposition of Farm Land (sec. 214 of the Act and sec. 1252 of the code)

Prior law.—Existing law allows a taxpayer engaged in the farming business to elect to currently deduct expenditures for soil and water conservation purposes (sec. 175) and land clearing expenditures (sec. 182) from ordinary income. Under normal business accounting rules, these expenditures would be added to the basis of the farm land and thus would reduce the amount of capital gain realized when the land is sold. However, by allowing these expenses to be currently deducted, they reduce ordinary income rather than capital gain income.

General reasons for change.—The current deduction allowed for soil and water conservation expenditures and land clearing expenditures with respect to farm land, combined with the capital gains treatment allowed under prior law on the sale of the farmland permitted high-income taxpayers to convert ordinary income into capital gains. These taxpayers could purchase farm land, deduct these expenditures from their high-bracket nonfarm income, and then receive capital gain treatment on the sale of the farm land.

Explanation of provision.—Under the Act, there is a recapture of a specified portion of the deductions allowed to a taxpayer for soil and water conservation expenditures or land clearing expenditures when the farm land to which they relate is disposed of, if the disposition occurs within nine years after it was acquired and if a tax benefit was derived from the deductions. In other words, the gain arising on the disposition of the farm land is treated as ordinary income, rather than as capital gain, to the extent of the specified portion of the prior deductions for these expenditures. This treatment applies, however, only with respect to deductions allowed for these expenditures which are made after December 31, 1969.

The amount of the deductions previously allowed for soil and water conservation expenditures or land clearing expenditures which are subject to recapture is determined as follows. If the farm land is

disposed of within five years after the time it was acquired, there is a full recapture of the previously allowed expenditures. The amount of the deductions subject to recapture then is reduced by 20 percent a year for dispositions of farm land within the sixth through the tenth year after it was acquired. Thus, the percentage of the deduction subject to recapture is 80 percent if the disposition occurs in the sixth year after acquisition, 60 percent if the disposition occurs in the seventh year, 40 percent if it occurs in the eighth year, and 20 percent if it occurs in the ninth year. If the farm land is disposed of 10 years or more after it was acquired, there is no recapture.

In no event, however, is an amount greater than the amount of gain arising on the disposition of farm land treated as ordinary income under this recapture provision. For this purpose, the amount of gain arising on a sale or exchange (or involuntary conversion) of farm land is the excess of the amount realized on the sale or exchange over the adjusted basis for the land. In the case of other types of dispositions, the amount of gain is determined with reference to the fair market value of the land.

Any gain treated as ordinary income as a result of this recapture provision will generally be recognized notwithstanding any other provision of the income tax law. This recapture provision, however, does not apply to gain arising on the disposition of farm land to the extent that the gain is treated as ordinary income because of the application of the excess deductions account recapture provision.

For purposes of this recapture rule, rules similar to those provided at present with respect to the recapture of depreciation on tangible personal property, relating to exceptions and limitations and to adjustments to basis, are applied.

Effective date.—This provision applies to taxable years beginning after December 31, 1969, but only to the extent of deductions allowed for expenditures made after that date.

7. Crop Insurance Proceeds (sec. 215 of the Act and sec. 451 of the code)

Prior law.—A taxpayer who uses the cash basis method of accounting generally must report income in the year in which it is received. Accordingly, under prior law a farmer who used this method of accounting and who received insurance proceeds as a result of the destruction of, or damage to, his crops had to include the insurance proceeds in income for the year of receipt.

General reasons for change.—Under prior law a problem arose in that the crops which were destroyed might not, under normal circumstances, have been reported as income until the following year. As a result, the reporting of the insurance proceeds in the earlier year could result in a doubling up of income in that year (since the farmer in the forefront of that year could also be reporting the income from the sale of crops from the prior year). In the next year, since the farmer had only deductions and no income to report, he was likely to have a net operating loss to carry back and offset against income in the year in which the double amount was reported. However, the farmer in such cases was faced with the advance payment of tax and also might lose the benefit of his personal exemptions and his standard or itemized deductions in the year of the loss.

Explanation of provision.—In order to ameliorate the hardship described above, the Act provides that a taxpayer who uses the cash

receipts and disbursements method of accounting may elect to include crop insurance proceeds in income for the year following the year of damage or destruction, if he normally would have reported the income from the crop in that following year. For this election to be available, the taxpayer must establish that under his practice he would have reported the income from the crops in a taxable year following that in which the damage or destruction occurs.

Generally, farmers will be able to meet the requirement of establishing their practice by reference to their records which show the delivery of their crops in the year following the year in which they are harvested.

Effective date.—This provision applies with respect to taxable years ending after December 30, 1969.

8. Capitalization of Costs of Planting Citrus Groves (sec. 216 of the Act and sec. 278 of the code)

Prior law.—Under prior law, taxpayers engaged in the business of growing citrus fruit were treated as engaged in the business of farming and thus could use the more liberal accounting rules which are available for computing income or loss from farming but which are not generally applicable to other types of businesses. For example, a taxpayer could deduct expenditures for developing a citrus grove, a business asset, which other taxpayers would have to capitalize.

In addition, capital gains treatment quite often was available on the sale of a citrus grove.

General reasons for change.—Although the special farm accounting rules were adopted to relieve farmers of bookkeeping burdens, these rules were used by some high-income taxpayers who were not primarily engaged in farming to obtain a tax loss where there was no economic loss by planting and developing a citrus grove and then deducting the expenses involved from their high-bracket, nonfarm income. In addition, when these high-income taxpayers sold their investment in the citrus grove they often received capital gains treatment on the sale. The combination of the current deduction against ordinary income for expenses of a capital nature and the capital gains treatment available on the sale of citrus groves produced significant tax advantages and tax savings for these high-income taxpayers. This treatment also led to large speculative tax-motivated plantings of citrus groves in various areas of the country which have had unfavorable economic consequences for the citrus industry. In some areas, the result was overproduction of citrus fruits which caused an undue depression of prices to the detriment of bona fide citrus growers.

Explanation of provision.—The Act provides that the expenditures attributable to purchasing, planting, cultivating, maintaining, or developing a citrus grove must be capitalized if the expenditures are incurred prior to the end of the third taxable year after the year in which the grove is planted. Thus, expenditures incurred during this period cannot be currently deducted, but rather must be charged to capital account.

This capitalization rule does not apply to expenditures incurred in replanting a citrus grove which was damaged or destroyed (while in the hands of the taxpayer) by freeze, drought, disease, pests, or casualty.

Effective date.—This provision generally applies to taxable years beginning after December 31, 1969. It does not apply, however, to

expenditures in connection with citrus groves which were planted or replanted prior to December 30, 1969.

9. Revenue Effect

The revenue increase under the farm loss provisions of the Act (apart from the provisions relating to citrus groves) is estimated at \$5 million in calendar year 1971, \$10 million annually for 1972 through 1974 and \$25 million annually in the long run. In addition, the revenue increase under No. 8 above, *Capitalization of Costs of Planting Citrus Groves*, is estimated at \$5 million in 1970, and \$10 million annually for 1971 and later years.

E. LIMITATION ON DEDUCTION OF INTEREST

(Sec. 221 of the Act and sec. 163 of the code)

Prior law.—Prior law allowed individual taxpayers an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

General reasons for change.—An unlimited deduction for interest allows taxpayers to voluntarily incur a substantial interest expense on funds borrowed to purchase growth stocks (or other investments initially producing low income) and to then use the interest deduction to shelter other income from taxation. Where a taxpayer's investment produces little or no current income, the effect of allowing a current deduction for interest on funds used to make the investment is to allow the interest deduction to offset other ordinary income even though the gains finally obtained from the investments might result in capital gains.

Explanation of provision.—The Act places a limitation, in the case of individuals (and other noncorporate taxpayers), on the deduction of interest on funds borrowed to acquire or carry investment assets. This limitation applies for taxable years beginning after 1971. Under the Act, an individual may currently deduct in full interest incurred for this purpose ("investment interest") to the extent it does not exceed his net investment income and long-term capital gains arising on the disposition of investment assets by more than \$25,000 (\$12,500 in the case of a separate return by a married individual and zero in the case of a trust.) To the extent the individual's investment interest is in excess of this amount, only one half of the interest may be currently deducted.

This limitation applies only to interest on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, investment income means income from interest, dividends, rents, royalties, short-term capital gains arising on the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245 and 1250 of the code), but only if the income is not derived from the conduct of a trade or business.

Interest incurred on funds borrowed for other purposes such as a home mortgage, installment purchases, consumer goods, and personal or student loans is not affected by the limitation. In addition, interest on funds borrowed in connection with a trade or business is not affected by the limitation. In this connection, interest on indebtedness incurred

or continued with respect to the construction of property which will be used in a trade or business when completed is not considered investment interest and is not affected by the limitation.

Rental property is considered as investment property subject to the limitation, rather than as property used in a trade or business, if the property is rented under a net lease arrangement. The determination of whether property is rented under a net lease arrangement is made separately for each year. For this purpose, a lease is considered to be a net lease for a taxable year either if the taxpayer's trade or business expenses with respect to the property which are deductible solely by reason of section 162 of the code are less than 15 percent of the rental income from the property or if the taxpayer is guaranteed a specified return or is guaranteed, in whole or in part, against loss of income.

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

The long-term capital gain income taken into account for purposes of the limitation is the excess for the taxable year of the taxpayer's net long-term capital gain upon the disposition of investment property over his net short-term capital loss on the disposition of this type of property. For this purpose 100 percent of the long-term capital gain is taken into account.

The limitation provided by the Act operates in the following manner. Interest subject to the limitation (that is, investment interest) which is in excess of \$25,000 (\$12,500 in the case of a separate return by a married individual and zero in the case of a trust) first offsets the amount of the taxpayer's net investment income. To the extent the interest exceeds the taxpayer's net investment income, it then is offset against net long-term capital gains. (Long-term capital gains which are offset by interest in this manner are treated as ordinary income, rather than as capital gains, in computing the 50 percent capital gains deduction, the alternative capital gains tax, and the minimum tax on tax preferences.) Any investment interest in excess of these amounts may be currently deducted by the taxpayer only to the extent of one-half of the excess interest.

Investment interest for which a deduction is disallowed in a year (year one) because of the limitation may be carried over to the following year (year two). The amount of the disallowed interest carried over to year two which may be deducted in year two is limited to one-half of the amount of the taxpayer's net investment income (which as indicated above does not include long-term capital gains) for year two which is not offset by investment interest paid or accrued in year two. Investment interest paid or accrued in year two is considered to offset net investment income for year two only to the extent the interest exceeds \$25,000. A carryover of disallowed investment interest which cannot be used in year two because of the above-described limitation may be carried over to succeeding years. The amount of any further carryover from year two, however, is reduced by the amount of the

long-term capital gains deduction to which the taxpayer was entitled for year two (whether or not the taxpayer claims the deduction). Further carryovers from subsequent years, such as from year three to year four, would be similarly reduced. A carryover is not available for disallowed interest to the extent it exceeds the taxpayer's taxable income for the year the interest is paid or accrued (that is, to the extent the disallowed interest would not have reduced the taxpayer's taxable income).

The application of these carryover rules may be illustrated by the following example. Assume that for 1972 an individual has \$200,000 of investment interest, \$30,000 of net investment income, and \$45,000 of net long-term capital gains on the disposition of property held for investment. Under the basic limitation on the deduction of investment interest, the individual would be allowed to deduct \$150,000 of the investment interest for 1972. This amount is determined as follows:

Amount generally deductible.....	\$25, 000
Amount of net investment income.....	30, 000
Amount of net long-term capital gains.....	45, 000
Sum.....	100, 000
1/2 of investment interest (\$200,000), over sum of above items (\$100,000).....	50, 000
Allowable investment interest deduction.....	150, 000

(The \$45,000 long-term capital gain offset by investment interest would not be eligible for the alternative capital gains tax or the 50 percent capital gains deduction.)

Under the carryover rules, the \$50,000 of investment interest in this example which is not deductible in 1972 could be carried over to 1973. Assume that in 1973 the individual paid \$40,000 of investment interest and had net investment income of \$75,000. The \$40,000 of investment interest paid in 1973 would first be offset against the generally allowable \$25,000 amount. The remaining \$15,000 of that investment interest then would be offset against the \$75,000 of investment income for 1973. This would leave \$60,000 of net investment income for 1973 which is not offset by investment interest paid in that year and, accordingly, a deduction would be allowed in 1973 for \$30,000 of the \$50,000 of investment interest disallowed in 1972 and carried over to 1973 (\$30,000 being one-half of the \$60,000 of investment income for 1973 which is not offset by investment interest paid in that year). Assume further that the taxpayer had net long-term capital gains of \$28,000 for 1973 on the disposition of property held for investment with respect to which a \$14,000 long-term capital gains deduction would be allowable. In determining the amount of investment interest disallowed for 1972 which would remain to be carried over to 1974, the \$20,000 carried over to 1973 but not deductible in that year would be reduced by the \$14,000 long-term capital gains deduction allowable for 1973. Accordingly, the amount of the investment interest disallowed for 1972 which would be eligible for carryover to 1974 would be \$6,000.

In the case of partnerships, the limitation on the deduction of interest is applied only at the partner level. In other words, each partner separately takes into account his share of the partnership's investment interest and other items of income and expense taken into account for purposes of the limitation. Similar treatment is provided

in the case of subchapter S corporations. In this case, each shareholder of the corporation takes into account the investment interest of the corporation and the other items of income and expense which are taken into account for purposes of the limitation on a pro rata basis in a manner consistent with the way in which the shareholders of the corporation take into account a net operating loss of the corporation.

Effective date.—This provision applies with respect to taxable years beginning after December 31, 1971. However, the limitation does not apply to investment interest attributable to a specific item of property, if the indebtedness with respect to the property is for a specified term and either was incurred prior to December 17, 1969, or was incurred on or after that date pursuant to a pre-December 17 binding written contract or commitment. The investment income and investment expenses attributable to such a specific item of property also are not taken into account in applying the limitation.

Revenue effect.—It is anticipated that this provision will result in an annual revenue gain of \$20 million for 1972 and later years.

F. MOVING EXPENSES

(Sec. 231 of the Act and secs. 217 and 82 of the code)

Prior law.—Prior law allowed, under specified conditions, a deduction from gross income for the following job-related moving expenses: (1) the cost of transporting the taxpayer and members of his household from the old to the new residence; (2) the cost of transporting their belongings; and (3) the cost of meals and lodging en route. The deduction was available to new employees (whether or not reimbursed) and to unreimbursed transferred employees, but not to self-employed individuals.

For a deduction for moving expenses to be allowed, the taxpayer's new principal place of work had to be located at least 20 miles farther from his former residence than was his former principal place of work (if the taxpayer had no former place of work, then at least 20 miles from his former residence). In addition, to obtain the deduction the taxpayer had to be employed full-time during at least 39 weeks of the 52 weeks immediately following his arrival at the new place of work.

The position of the Service under prior law also allowed existing employees whose moving expenses were reimbursed to exclude reimbursements for the above categories of expense (to the extent of the expenses) whether or not they satisfied the tests prescribed by the law for the deduction of moving expenses by other employees.

Prior law did not specifically deal with other reimbursed moving expenses;¹ however, the courts generally held that reimbursements for moving expenses, other than those which were deductible, had to be included in gross income.

General reasons for change.—The mobility of labor is an important and necessary part of the nation's economy, since it reduces unemploy-

¹ Prior law provided that no deduction was allowable for moving expenses for any item to the extent that the taxpayer received reimbursement or other expense allowance for such item unless the amount of the reimbursement or other expense allowance was included in the taxpayer's gross income. Thus, if an employee had claimed a deduction for moving expenses and subsequently received a reimbursement for those expenses which he did not include in his gross income, then he had to file an amended return for the taxable year in which the deduction was claimed.

ment and increases productive capacity. It has been estimated that approximately one-half million employees are requested by their employers to move to new job locations each year. In addition, self-employed individuals relocate to find more attractive or useful employment. Substantial moving expenses often are incurred by taxpayers in connection with employment-related relocations, and these expenses may be regarded as a cost of earning income.

The Congress believed that more adequate recognition should be given in the tax law to expenses connected with job-related moves. In addition, the Congress concluded that equity required that the moving expense deduction be made available on a comparable basis for self-employed persons who move to a new work location. Finally, it was desired to equalize fully the tax treatment for the moving expenses of new employees and unreimbursed transferred employees with the treatment accorded reimbursed employees.

Explanation of provision.—The Act broadens the categories of deductible moving expenses, provides that reimbursed taxpayers are to be treated in the same manner as unreimbursed taxpayers, increases the minimum 20-mile test to 50 miles, extends the moving expense deduction to the self-employed, and refines the application of the 39-week test which must be satisfied for the deduction to be available.

A moving expense deduction is allowed by the Act for three additional categories of expenses: (1) pre-move house-hunting trips; (2) temporary living expenses at the new job location; and (3) qualified expenses of selling, purchasing or leasing a residence. These additional moving expense deductions are subject to an overall limit of \$2,500, with a \$1,000 limit on the first two categories.

The pre-move house-hunting trip expenses include the cost of transportation, meals, and lodging for the taxpayer and members of his household paid for the principal purpose of searching for a new residence. The deduction is not available, however, unless the taxpayer (a) has obtained employment at a new principal place of work before the trip begins, and (b) travels from his former residence to the general area of his new principal place of work and returns.

The temporary living expenses at the new job location include costs of meals and lodging for the taxpayer and members of his household at the new job location while waiting to move into permanent quarters. However, only those expenses incurred within 30 consecutive days after obtaining employment are deductible.

Residence sale and purchase expenses which qualify for the deduction are those reasonable expenses incident to the sale or exchange by the taxpayer (or his spouse) of his former residence and also expenses incident to his purchase of the new residence. Reasonable expenses incurred in settling an unexpired lease on an old residence or acquiring a lease on a new residence (except any amounts representing security deposits or payments or prepayments of rent) also may be deducted. The expenses related to the sale of the former residence include a real estate agent's commission, escrow fees, and similar expenses reasonably necessary to effect the sale or exchange of the residence. Expenses for fixing up a residence to assist in its sale are not in this category. The expenses related to purchasing the new residence include attorney's fees, escrow fees, appraisal fees, title costs, loan placement charges (which do not represent interest) and similar expenses reasonably necessary to effect the purchase of the new resi-

dence. These expenses do not include any portion of real estate taxes, any payments which represent interest, or any portion of the purchase price of the residence. A residence for this purpose includes a house, an apartment, a cooperative or condominium dwelling unit, or other similar dwelling.

The selling expenses on the former residence which are deductible under this provision do not reduce the amount realized on the sale of the residence for purposes of determining gain. Similarly, the expenses of purchasing a residence which have been deducted may not be added to the cost basis of the new residence for purposes of determining gain. These adjustments were necessary to prevent double tax benefits.

If a husband and wife both commence work at a new principal place of employment within the same general location, the \$2,500 limit rule is to be applied as if there were only one commencement of work. Where a married couple files separate returns, the overall limit for these additional moving expenses is \$1,250 for each, and the house-hunting trip and temporary living expenses are limited to \$500 out of the \$1,250. In those cases where the moving expenses (both those deductible under prior law and those for which a deduction is provided by the Act) relate to an individual other than the taxpayer, a deduction is to be allowed only if the individual lives in both the former and the new residence and is a member of the taxpayer's household.

The Act also provides that the reimbursement of expenses of moving from one residence to another are to be included in the taxpayer's gross income (as compensation for services). Under this provision, taxpayers include the reimbursements in gross income but then are permitted to take deductions to the extent permitted under the provisions for the deduction of moving expenses.

Since compensation for services is generally subject to the withholding of income tax, moving expense reimbursements are subject to the general withholding rules. However, the withholding provisions (sec. 3401(a)) do not apply to reimbursements to the extent it is reasonable to believe that a moving expense deduction will be allowable (under sec. 217).

The Act replaces the 20-mile test of prior law with a 50-mile test. Under the 50-mile rule, no deduction is allowed unless the taxpayer's new principal place of work is at least 50 miles farther from his former residence than was his former principal place of work. If the taxpayer has no former principal place of work, the deduction is allowed only if the distance between the new principal place of work and his former residence is at least 50 miles. In applying the 50-mile test, the distance between the two points is to be the shortest of the more commonly traveled routes between these two points.

Deductions are allowed under this provision only if the taxpayer during the 12-month period immediately following his arrival at his new principal place of work is a full-time employee for at least 39 weeks. However, in the case of self-employed persons (who did not qualify for any moving expense deduction under prior law) deductions are allowed if during the 24-month period immediately following their arrival at the new principal place of work they perform services on a full-time basis during at least 78 weeks, of which not less than 39 weeks occur during the 12-month period immediately following the arrival at their new place of work.² Whether a self-employed taxpayer performs

² The self-employed rule also applies to a person who has served both as an employee and in a self-employed capacity but who is unable to meet the 39-week employee test.

services on a full-time basis depends upon the customary practices of his occupation. (These provisions do not include the semi-retired, part-time students, or other similarly situated self-employed taxpayers who work only a few hours each week.)

If a taxpayer has not satisfied his 39-week or 78-week test before the time for filing his income tax return for the year during which the moving expenses would be deductible, he may (as under prior law) nevertheless claim a deduction for these expenses incurred during the earlier taxable year if it is possible for him at the time of filing his return to still satisfy the test. If this condition is not satisfied at the close of the subsequent year in which the test period of time ends, an amount equal to the expenses which were deducted in the earlier taxable year must be included in the taxpayer's gross income for that subsequent year.

The 39-week test is waived if the employee is unable to satisfy it as a result of death, disability, or involuntary separation (other than for willful misconduct) from the service of, or transfer for the benefit of, an employer after obtaining full-time employment in which the taxpayer could reasonably have been expected to satisfy the requirement. The new 78-week test is waived for self-employed individuals in the case of death or disability.

The term "self-employed individual" is defined as an individual who performs personal services as the owner of an entire interest in an unincorporated trade or business, or as a partner in a partnership carrying on a trade or business. Under the Act, an individual who commences work at a new principal place of work as a self-employed individual is treated as having obtained employment when he has made substantial arrangements to commence such work.

Effective date.—These provisions generally apply with respect to taxable years beginning after December 31, 1969. However, no deduction is allowed for an item to the extent the taxpayer received (or accrued) reimbursement or other expense allowance for such item in a taxable year beginning on or before December 31, 1969, which was not included in his gross income. In addition, a taxpayer may elect to have these amendments not apply with respect to moving expenses paid or incurred before July 1, 1970, in connection with the commencement of work by the taxpayer as an employee at a new principal place of work of which the taxpayer had been notified by his employer on or before December 19, 1969.

Revenue effect.—The changes in the tax treatment of moving expenses adopted in the Act are expected to provide tax relief amounting to an estimated \$110 million a year to individual income taxpayers.

G. MINIMUM TAX

(Sec. 301 of the Act and secs. 56, 57, and 58 of the code)

Prior law.—Under prior law, many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions.

Both individuals and corporations, for example, paid the equivalent of the regular income tax on only part of their long-term capital gains. Individuals with large interest payments on funds borrowed to carry growth stock used the interest deduction to reduce other unrelated

taxable income. They could offset practically all their income in this manner and, as a result, paid little or no tax. Similarly, individuals and corporations escaped tax on a large part of their economic income as a result of receiving accelerated depreciation on real property and percentage depletion in excess of cost depletion. Financial institutions also paid lower taxes than other corporations to the extent that their deductions for bad debt reserves exceeded the deductions that would be allowed on the basis of actual loss experience.

General reason for change.—The prior treatment imposed no limit on the amount of income which an individual or corporation could exclude from tax as the result of various tax preferences. As a result, there were large variations in the tax burdens placed on individuals or corporations with similar economic incomes, depending upon the size of their preference income. In general, those individual or corporate taxpayers who received the bulk of their income from personal services or manufacturing were taxed at relatively higher tax rates than others. On the other hand, individuals or corporations which received the bulk of their income from such sources as capital gains or were in a position to benefit from net lease arrangements, from accelerated depreciation on real estate, from percentage depletion, or from other tax-preferred activities tended to pay relatively low rates of tax. In fact, many individuals with high incomes who could benefit from these provisions paid lower effective rates of tax than many individuals with modest incomes. In extreme cases, individuals enjoyed large economic incomes without paying any tax at all. This was true for example in the case of 154 returns in 1966 with adjusted gross incomes of \$200,000 a year (apart from those with income exclusions which do not show on the returns filed). Similarly, a number of large corporations paid either no tax at all or taxes which represented very low effective rates.

Explanation of provision.—The Act provides a minimum tax on specified tax preference income received by individuals and corporations in order to make sure that all taxpayers are required to pay significant amounts of tax on their economic income. The minimum tax amounts to 10 percent of the sum of an individual's or corporation's (or estate's or trust's) tax preference income (i.e., income which would be taxed but which is not because of a tax preference) to the extent it exceeds \$30,000 plus the regular income tax (reduced by any foreign tax credit, retirement income credit or investment credit). If a taxpayer has a net operating loss that results in loss carryovers to future years, the minimum tax on an amount of preference income equal in size to the carryovers is deferred until the year when the carryovers are used.

The items of tax preference included in the base of the 10 percent tax are as follows:

(a) *Excess investment interest.*—This is the excess of investment interest over net investment income. Investment income consists of gross income from interest, dividends, rents and royalties, net short-term capital gain from property held for investment purposes, and amounts treated as ordinary income under the recapture rules (secs. 1245 and 1250) but only to the extent that such income and gain are not derived from the conduct of a trade or business. Investment expenses for this purpose include State and local property taxes, bad debts, straight line depreciation, the dividends received deduction, amortizable bond premium, cost depletion, and certain other deduc-

tions attributable to the production of income to the extent these expenses are directly attributable to the production of such investment income. Investment interest expense, as distinguished from other interest expense, is interest on indebtedness incurred or continued to purchase or carry property held for investment purposes. Interest with respect to property which is subject to a net lease entered into after October 9, 1969, is treated as a tax preference under this provision.

Excess investment interest is regarded as a preference only for individuals, estates, trusts, subchapter S corporations, and personal holding companies, and only until 1972 when the interest limitation deduction provision becomes applicable.

(b) Accelerated depreciation on personal property subject to a net lease.—This is the accelerated depreciation in excess of the straight-line depreciation. Net leases for this purpose involve those situations where the lessor is either guaranteed a specific return or is guaranteed in whole or in part against the loss of income. Net leases also include those situations where the trade or business expense deductions are less than 15 percent of the rental income produced by the property.

The preference relating to accelerated depreciation on personal property subject to a net lease applies only in the case of individuals, estates, trusts, subchapter S corporations, and personal holding companies.

(c) Accelerated depreciation on real property.—This is the excess of the rapid depreciation allowed over straight line depreciation.

(d) Amortization of rehabilitation expenditures.—This is the excess of the amortization deduction over straight line depreciation.

(e) Amortization of certified pollution control facilities.—This is the excess of the amortization deduction over accelerated depreciation.

(f) Amortization of railroad rolling stock.—This is the excess of the amortization deduction over accelerated depreciation.

(g) Tax benefits from stock options.—In the case of qualified stock options or restricted stock options, this is the excess of the fair market value of the stock at the time of exercise of the option over the option price of the stock.

(h) Bad debt deductions of financial institutions.—In the case of a bank, savings and loan association, mutual saving bank or other financial institution, this is the amount by which the bad debt reserve deduction exceeds the amount which would be allowable to the bank or other institution had it maintained its bad debt reserve on the basis of its own actual bad debt loss experience or in the case of a new institution, industry experience.

(i) Depletion.—This is the excess of the depletion deduction allowance taken for the year over the adjusted basis of the property (reduced for depletion taken in prior years.)

(j) Capital gains.—In the case of individuals, one-half of the net long-term capital gain, to the extent it exceeds the net short-term capital loss. In the case of corporations, the tax preference is the excess of the net long-term capital gain over the net short-term capital loss, multiplied by a ratio in which the denominator is the regular corporate rate (48 percent) and the numerator is the regular corporate rate, minus the rate applicable to capital gains in the case of corporations (28 percent in 1970 and 30 percent thereafter). In other words, the corporate capital gains are included among the tax preferences in the

ratio of the difference between their special tax rate and the general corporate tax rate to the general corporate tax rate.

Stock options and capital gains (items (g) and (j) above) which are derived from sources outside the United States, are subject to the minimum tax only if the foreign country taxes them at a preferential rate or does not tax them at all. The remaining items of tax preference, as set forth above, include preferences attributable to income derived from sources outside the United States only to the extent that these items result in foreign losses which reduce taxable income derived from sources within the United States. The amount of tax preferences so included is not to exceed the amount of such foreign losses. The foreign tax credit is not allowed against the 10-percent minimum tax.

Special rules are provided in order to cover the following situations:

(a) In the case of estates or trusts, the items of tax preference are attributed to the estate or trust and the beneficiaries in the same ratio as the income allocable to each. The \$30,000 exemption generally available is reduced insofar as the trust or estate is concerned in the proportion in which its income is allocated to its beneficiaries.

(b) In the case of members of a controlled group of corporations, the \$30,000 exemption is apportioned equally among the members of the group unless they agree to share the exemption in some other way.

(c) In the case of subchapter S corporations (where the income is taxed to the shareholders), items of tax preference are apportioned among the shareholders in the manner consistent with the manner in which a net operating loss is apportioned among the shareholders. However, where capital gains are taxed to both the subchapter S corporation and the shareholder (under section 1378 of the code), the capital gains tax preference is subject to the minimum tax at both the corporate and individual levels. In such a case, the amount treated as capital gain by the shareholder is reduced by the tax imposed under section 1378 (as under present law) and by the 10 percent minimum tax imposed at the corporate level.

(d) Regulated investment companies are not subject to the minimum tax to the extent they pass through to shareholders amounts attributable to tax preferences. However, their shareholders are subject to minimum tax on capital gains tax preferences passed through to them. In addition, the shareholders are deemed for purposes of the minimum tax to have received the other tax preferences of the regulated investment company in proportion to the amounts that are distributed to them by the regulated investment company.

(e) The tax preferences of a common trust fund are treated as tax preferences of the participants of the fund and are apportioned pro rata among such participants.

(f) In the case of a husband and wife filing separate returns, the exemption is \$15,000 for each spouse.

Effective date.—This provision applies with respect to taxable years ending after December 31, 1969, but in applying the minimum tax to fiscal years beginning in 1969 and ending in 1970, the tax will be imposed on a pro-rata basis.

Revenue effect.—The minimum tax is estimated to increase revenue \$590 million in calendar year 1970, \$600 million in 1972 and \$635 million in the long run

H. INCOME AVERAGING

(Sec. 311 of the Act and secs. 1301–1305 of the code)

Prior law.—Prior law provided a general averaging provision for an individual whose income fluctuates widely from year to year or increases rapidly over a short period. Generally, this averaging provision allowed the excess of the current year's taxable income over $1\frac{1}{2}$ times the average taxable income of the prior 4 years to be taxed at lower bracket rates than would otherwise apply, roughly approximating the tax which would have been imposed had the receipt of this excess income been spread evenly over the 5-year period.

The income subject to averaging was determined by calculating the extent to which the current year's taxable income (after certain exclusions) exceeded $133\frac{1}{3}$ percent of taxable income (with approximately the same adjustments) in the 4 prior years. If this excess over the $133\frac{1}{3}$ percent, which was known as "averagable income," was more than \$3,000, averaging was available to the individual. The tax on this "averagable income" was determined by taking $\frac{1}{5}$ of this income and adding it to $133\frac{1}{3}$ percent of the average of the taxable income (with adjustments) for the 4 prior years. The tax on this additional amount was then multiplied by 5.

Certain types of income such as long-term capital gains, wagering income, and income from gifts if in excess of \$3,000 (as well as other relatively rare types of income) were not eligible for averaging under prior law. If a taxpayer had taxable income not eligible for averaging, the tax computation required additional steps because it was necessary to divide the income into several segments in order to determine the tax attributable to one-fifth of averagable income as well as the tax on the nonaveragable income.

In addition, in order to determine whether the alternative tax on capital gains was advantageous, the taxpayer needed to go through a further 14-step computation. This computation was designed to determine whether the alternative tax on capital gains was less than the tax on the two segments of current year capital gains (average base period capital gains plus excess of current year capital gains over average base period capital gains).

General reasons for change.—The $133\frac{1}{3}$ -percent test described above was considered too restrictive by the Congress in that it denied the benefits of averaging to taxpayers with a substantial increase in income and reduced the benefits of averaging for those who were eligible.

Denying averaging to certain types of income, particularly long-term capital gains, and permitting the alternative tax on capital gains for those who used averaging resulted in a complex provision and a complicated tax form. This complexity made it difficult for taxpayers to determine whether they would benefit from averaging and undoubtedly deterred some eligible taxpayers from making use of averaging. Simplifying the averaging provision should make it more generally available and usable.

In addition, Congress believed it was desirable to extend the benefits of averaging to long-term capital gains in order to maintain a better balance between taxation of capital gains and other types of income, especially in view of the increased tax on capital gains resulting from other provisions of the Tax Reform Act of 1969.

Explanation of provision—The Act allows a taxpayer to average that part of his current year's taxable income (after adjustment for certain relatively rare items) which exceeds 120 percent of his average base period taxable income (if he meets the \$3,000 test). Thus, for averaging to be available, the taxpayer's excess income in the current year now has to be only 20 percent greater than his average income for the prior 4 years rather than 33½ percent greater as under prior law.

The Act also provides that net long-term capital gains, income from gifts, and wagering income are to be eligible for averaging. Accordingly, for purposes of averaging, it is no longer necessary for the taxpayer to make adjustments to his current year's income for these items or to adjust his prior 4 years' income for capital gains or income from gifts. In addition, the Act provides that income received by the beneficiary of an accumulation trust is to be excluded from income eligible for averaging (and base period income) since this income has its own special tax computation (see Section J, "*Accumulation Trusts, Multiple Trusts, Etc.*").

The Act also provides that taxpayers who elect income averaging may not elect the alternative tax on capital gains or the 50-percent limit on earned income (see item 5, Section AA, "*50 Percent Maximum Tax on Earned Income*"). These special tax limits are not made available in addition to averaging primarily because of the complexity they would add but also because their purposes are, to some extent, achieved by the new averaging provision in the case of taxpayers eligible for income averaging.

Effective date.—These changes made by the Act apply to taxable years beginning after December 31, 1969.

Revenue effect.—The liberalized averaging provided by the Act will grant tax benefits amounting to an estimated \$300 million a year to individual income taxpayers.

I. RESTRICTED PROPERTY

(Sec. 321 of the Act and secs. 83, 402, and 403 of the code)

Prior law.—Prior law did not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans, although these arrangements were dealt with in Treasury regulations.

A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which affect its value. A restricted stock plan may cover only one employee or it may cover a number of employees. The stock transferred under a plan may be stock in the employer corporation, stock of another company—often an unrelated growth company—or even shares of a mutual fund.

The restrictions which are imposed on the stock are of various types. One type of restriction often imposed requires the employee to return the stock to the employer if he does not complete a specified additional period of employment and prohibits the employee from selling the stock in the interim. Another common type of restriction provides that the employee may not sell the stock for a specified period of time, such as a 5-year period, or until he retires.

Treasury regulations under prior law, generally, did not require immediate taxation when the employee received restricted stock. Tax was deferred until the time the restrictions lapsed; at that time, if the stock had increased in value, only the value of the stock when it was transferred to the employee (determined without regard to restrictions) was treated as compensation. If the stock had decreased in value in the interim, then the lower value at the time the restrictions lapsed was considered the amount of compensation. Thus, under the regulations there was a deferral of tax with respect to this type of compensation, and any increase in the value of the stock between the time it was granted and the time when the restrictions lapsed was not treated as compensation.

The regulations also provided that the employer was entitled to deduct compensation at the time and in the same amount as the employee was considered to have realized income. In the case of non-exempt trusts, however (where the income to the recipient was deferred if his rights to the contribution were forfeitable), employers under the regulations were not allowed deductions for property contributed to such trusts.

General reasons for change.—Prior tax treatment of restricted stock plans was significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock was placed in an employee's trust rather than given directly to the employee subject to restrictions. If an employer transferred stock to a trust for an employee and the trust provided that the employee would receive the stock at the end of 5 years if he was alive at that time, the employee was treated as receiving, and was taxed, on the compensation in the amount of the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust, gave the stock directly to the employee subject to the restriction that it could not be sold for 5 years, then the employee's tax was deferred until the end of the 5-year period. In the latter situation, the employee actually possessed the stock, voted it, and received the dividends; yet his tax was deferred. In the case of the trust, he had none of these benefits, yet he was taxed at the time the stock was transferred to the trust.

Explanation of provision.—The Act provides that a person who receives a beneficial interest in property, such as stock, by reason of his performance of services must report as income in the taxable period in which received, the value of the property unless his interest in the property is subject to a substantial risk of forfeiture and is nontransferable.¹ The amount included in income is the excess of the fair market value of the property over the amount paid for it. The fair market value of the property is determined without regard to any restrictions, except a restriction which by its terms will never lapse.

If the property is subject to a substantial risk of forfeiture and is nontransferable, the employee is not required to recognize any income with respect to the property until his interest in the property either becomes transferable or no longer is subject to such risk. A substantial risk of forfeiture is considered to exist where the recipient's

¹ Also included under this rule are cases where the property is transferred to a person other than the person performing the service (other than the person for whom the services were performed).

rights to the full enjoyment of the property are conditioned upon his future performance of substantial services. The question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances. An interest in property is considered to be transferable only if the rights of the transferee are not subject to any substantial risk of forfeiture. However, a property would not be considered to be subject to a substantial degree of forfeiture, for example, where the employee receives a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it.

An employee is not taxed, either when he receives forfeitable property or when he gives it to another person, if it remains subject to forfeitability in the hands of the donee. However, the employee (and not the donee) is taxable at the time the donee's rights become nonforfeitable. If an employee who has a forfeitable interest in property sells the property in an arm's length transaction, the employee is treated as realizing income at that time.

When a person is allowed to sell property only at a price determined by formula, under a provision which will never lapse, this restriction is taken into account in valuing the property. The Act provides that the formula price is deemed to be the fair market value of the property, unless established to the contrary by the Secretary or his delegate.

If a restriction which was taken into account in valuing an item of property is canceled, the employee must recognize compensation income in the taxable year in which the cancellation occurs. The amount of income recognized is the excess of the fair market value of the property (computed without regard to the restriction) at the time of cancellation over the sum of: the fair market value of such property (computed by taking the restriction into account) immediately before the cancellation, and (2) the amount, if any, paid for the cancellation. It is not necessary to recognize income upon cancellation of a restriction if it can be established that the cancellation is not compensatory and that the person who would be entitled to a deduction if it were compensatory will treat the transaction as not compensatory.

To add flexibility, the Act allows employees the option of treating restricted property as compensation in the year it is received, even though it is nontransferable and subject to a substantial risk of forfeiture. If this election is made, the restricted property rules do not apply, and later appreciation in the value of the property is not treated as compensation. However, if the property is later forfeited, no deduction is allowed with respect to the forfeiture. The employee must make this election not later than 30 days after the date of transfer (or the date of enactment of the bill, if later). The election may not be revoked except with the consent of the Secretary of the Treasury or his delegate.

The holding period of restricted property is deemed to begin at the first time the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier (i.e., the time he is deemed to receive compensation).

The restricted property rules do not apply to: (1) a transaction which involves a stock option to which sec. 421 applies; (2) a transfer to or from a qualified trust (described in section 401(a)) or to a transfer under an annuity plan meeting the requirements of section

404(a)(2); (3) any amount excluded from gross income under section 403(b) in the case of annuities purchased for an employee by an educational or charitable (section 501(c)(3)) organization; (4) the transfer of an option without a readily ascertainable fair market value; or (5) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at date of grant.

The Act modifies the tax treatment of nonexempt trusts and non-qualified annuities to conform with the treatment of restricted property. Thus, if an employer contributes cash to a nonqualified trust or a nonqualified annuity plan and the employee's rights are forfeitable when the contribution is made but subsequently become nonforfeitable, the employee is to be taxable on the contribution at the first time his rights are not subject to a substantial risk of forfeiture instead of the later time when the contribution is distributed to him under the annuity contract (as contrasted to present law in the case of annuities purchased by exempt organizations). The amount subject to tax when the employee's interest becomes nonforfeitable is the value at that time of his interest in the trust (or the then value of the annuity contract). The value of the amounts subsequently contributed by the employer to the trust (or premiums subsequently paid) are included in the income of the employee when contributed or paid to the trust (or insurer), if the employee's interest in such amounts is nonforfeitable.

If restricted property is exchanged in a tax-free exchange for other property subject to substantially the same restrictions, the transaction will not cause the value of the property (less cost) to be included in income, but the property received in the exchange will be treated as restricted property. The same principle applies where property not subject to the restricted property provision because of the effective date is exchanged in a tax-free exchange. The property received in the exchange is not treated as subject to the new restricted property rules if it is subject to substantially the same restrictions as the property given up.

The Act allows the employer a deduction equal to the amount which the employee is required to recognize as income. The deduction is allowed in the employer's taxable year which includes the close of the taxable year in which the employee recognizes the income. Where restricted property is not subject to the new rules governing recognition of income, the prior law rules regarding the amount of the deduction continue to apply.

The Act provides, with respect to nonexempt trusts, that the employer is allowed a deduction for his contribution at the time that the employee recognizes income, providing that separate accounts are maintained for each employee. Under prior regulations, no deduction was ever allowed in those cases where the taxation of the income to the beneficiary of a nonexempt trust was deferred.

In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is treated as a capital contribution to the company which is entitled to a deduction in accordance with the restricted property rules. The parent company or the shareholder treats the contribution as an increase of the equity in the company which is entitled to the compensation deduction.

When property other than the employer company's own stock is given as compensation to an employee subject to a substantial restriction and the restriction lapses at a later date, the company is required, as under prior law, to recognize income in an amount by which the compensation deduction exceeds the company's basis in the property. Likewise, where the basis of the property exceeds the amount recognized as the compensation deduction, the employer can deduct this amount as a loss. The gain or loss would be reported in the employer's taxable year which includes the close of the taxable year in which the employee recognizes the compensation income. The Act makes no change in these rules.

Effective date.—Generally, the new rules apply to property transferred after June 30, 1969. The Act provides transitional rules which provide that the following situations are not subject to the new rules: (1) where property is transferred pursuant to a written contract entered into before April 22, 1969; (2) where the property is transferred upon the exercise of an option granted before April 22, 1969; (3) where the property is transferred before May 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969; or (4) where property is transferred before January 1, 1973, upon exercise of an option granted pursuant to a written contract entered into before April 22, 1969, with a third party (such as a tax-exempt foundation) to pay key employees (employed on or before April 22, 1969) a determinable amount of stock each year until a fixed number of shares have been transferred.

Revenue effect.—The revenue impact of this provision is believed to be small.

J. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

(Secs. 331, and 332 of the Act and secs. 663, 665, 666, 667, 668, 669, 677, and 6401 of the code)

Prior law.—Generally, a trust is treated as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of ordinary income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiary as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

Under prior law, when the trust distributed accumulated income to the beneficiaries, either they were not taxed on this income or they were taxed on the distributions under a so-called throwback rule. The throwback rule treats the income for tax purposes as if it had been received by the beneficiary in the year in which it was received by the

trust. The beneficiary recomputes his tax for these back years, adding the trust income to it and taking credit for the tax which had been paid by the trust on that income, and pays the additional tax due (if any) in the current year. The beneficiary was taxed, under prior law, however, only on the part of the distribution of accumulated income which represented income earned by the trust in the 5 years immediately prior to the distribution.

In addition to the limitation of its application to the 5 years preceding the year of distribution, the throwback rule did not apply to a distribution of less than \$2,000 or to several types of distributions:

- (1) a distribution of the income which was accumulated prior to the beneficiary's attaining of the age of 21;
- (2) a distribution of accumulated income to a beneficiary to meet his "emergency needs";
- (3) a distribution of accumulated income which was a final distribution, and which was made more than 9 years after the last transfer to the trust;
- (4) a distribution of accumulated income not in excess of \$2,000; and
- (5) certain periodic (not more than four distributions per beneficiary, each at least 4 years apart) mandatory distributions under trusts created prior to 1954.

If the accumulation distribution fell within one of these exceptions, the throwback rule did not apply, and the trust rather than the beneficiary was taxed on this income.

Where the trust has capital gains in a year, the trustee could allocate (or in most cases would be required to allocate) the capital gains to corpus. In this case, under prior law, these gains were taxed to the trust in the year earned and there were no further tax consequences upon the distribution of these capital gains in a later year.

General reasons for change.—The progressive tax rate structure for individuals was avoided when a grantor created trusts which accumulated income taxed at low rates, and the income in turn was distributed at a future date with little or no additional tax being paid by the beneficiary, even when he was in a high tax bracket. This result occurred because the trust itself was taxed on the accumulated income rather than the grantor or the beneficiary. This meant that the income in question, instead of being added on top of the beneficiary's other income and taxed at his marginal tax rate, was taxed to the trust at the starting tax rate. The throwback rule theoretically prevented this result, but the 5-year limitation and the numerous exceptions seriously eroded the basic principle that a beneficiary who receives income from property should pay tax on that income at his (rather than the trust's) marginal rates.

This avoidance device was compounded by the use of multiple trusts—the creation of more than one accumulation trust by the same grantor for the same beneficiary. The splitting of the income among many taxable entities resulted in still further reductions of the overall tax burden, since the accumulated income would then be taxed to each separate trust at lower rates than would be the case if only one trust were created.¹ Although the use of multiple trusts had been attacked

¹ The creation of multiple entities also serves to increase the number of \$100 exemptions allowed. Further, it provided for the multiplication of exemptions to the throwback rule under prior law, especially advantageous in the case of the \$2,000 exemption.

by the Internal Revenue Service, the courts have held that such trusts are valid in some cases.

The Congress concluded that taxpayers should not be allowed to utilize accumulation trusts to allow the beneficiaries of the trust either to escape paying tax or to substantially minimize their tax. The Congress believed that beneficiaries of these accumulation trusts should be taxed in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. Thus, under the Act the beneficiaries of accumulation trusts are placed in substantially the same tax status as beneficiaries of trusts which distribute their income currently. This approach is essentially the same treatment as has been applicable to foreign accumulation trusts created by U.S. persons since the passage of the Revenue Act of 1962.

Congress also concluded that capital gains of accumulation trusts also should be taxed to the beneficiaries in those cases where they do not distribute all of their ordinary income currently.

Explanation of provision.—The Act provides that beneficiaries are to be taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The Act eliminates the 5-year limitation and all the exceptions to the throwback rule, and provides an unlimited throwback rule with respect to an accumulation distribution. In this unlimited throwback approach, the Act removes generally the distinctions between treatment of distributions from domestic trusts and those from foreign trusts created by a U.S. person.

In the case of future accumulations of income by trusts, all of their income, other than income distributable currently, is to be taxed to the beneficiary upon its distribution to him. The amounts distributed are to be treated as if they had been distributed in the preceding years in which income was accumulated, but are includible in income of the beneficiary for the current year. However, under the Act the tax on such amounts is to be computed in either of two ways. One method, the "exact" method, is substantially the same as the method provided under prior law in the case of distributions subject to the "5-year throwback rule." The other is a "shortcut" method which does not require the more extensive computations required by the exact method.

Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years when earned. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust and the taxes of the beneficiary can be determined for each year. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary is allowed a credit for his share of the taxes paid by the trust during his life. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect averages the tax attributable to the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the

income received from the trust in the beneficiary's income for each of the 3 immediately prior years. The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust. Thus, if the accumulated income is attributable to 10 different years (although the trust may have been in existence longer than 10 years), then one-tenth of the amount distributed would be included in the beneficiary's income in each of the 3 prior years. The additional tax is then computed with respect to these 3 years and the average yearly additional tax for the 3-year period is determined. This amount is then multiplied by the number of years to which the trust income relates (10 in this example). The tax so computed may be offset by a credit for any taxes previously paid by the trust with respect to this income and any remaining tax liability is then due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution.

The Act allows a beneficiary, who was not alive during a year of the trust in which income was accumulated, to compute the tax on an accumulation distribution under either the exact or the short-cut method as if he were alive then and had no gross income (except for other distributions by accumulation trusts) and no deductions. For these purposes such beneficiary is deemed to be single, entitled to one exemption, the standard deduction and to be a calendar year taxpayer. Similarly, in the case of a beneficiary which is not a natural person, both methods of calculation are available and the foregoing assumptions apply, to the extent applicable. Because of this modification the Act allows a beneficiary to use the 3-year average when electing the short-cut method even if the number of trust years to which the income relates is less than 3.

The Act, however, does not allow the "short-cut method" to be used by a beneficiary if during any of his preceding taxable years to which an accumulation distribution was thrown back, prior accumulation distributions also were thrown back by two or more other trusts to the beneficiary. Congress believes this provision is necessary to prevent the creation of multiple trusts with staggered accumulation distributions in order to take advantage of the short-cut rule.

For purposes of averaging the accumulation distribution over the number of years the income was accumulated under the short-cut method, the Act excludes any year in which only a minimum of income was accumulated. This minimum amount is 25 percent of the average undistributed net income deemed distributed in any year. For example, if a \$10,000 accumulation distribution was made in the case of income accumulated over 10 years, the determination may not include any year in which less than 25 percent of \$1,000 (\$10,000 divided by 10 years) or \$250 was accumulated. If in this example there were 2 years in which less than \$250 was accumulated, then, for purposes of the 3-year averaging computation under the short-cut method, the \$10,000 would be divided by 8 years (10 years less 2 years disallowed) to determine the average amount deemed distributed each year.

The Act requires the beneficiary to include in his income for the years involved in either the exact or short-cut computations the income previously deemed distributed in the same years from prior accumulation distributions (whether from the same or another trust). Thus, if a taxpayer has used either the exact or short-cut method in an earlier

distribution and uses the exact method for a later distribution, for purposes of this exact computation, any income received from the trust in the earlier distribution must be included in his income for any year to which the second distribution relates, to the extent the earlier distribution was considered distributed in the same years. If in the current distribution the taxpayer chooses to use the short-cut method (having used either the exact or short-cut method in prior computations), he is likewise required to include in his income for each of the years involved in the computation (the 3 years for which the average increase in tax is computed) the amounts deemed distributed in those years from any prior accumulation distributions. In the case of two or more accumulation distributions from different trusts received in the same year, the beneficiary is to treat the distributions as having been made consecutively in whichever order he chooses.

The Act requires the beneficiary to use one of the alternative methods to compute the tax on his trust distribution (he does not have the alternative of including all of the trust income in his current year's tax base as he did under the prior throwback rules). This means that a partial tax is to be computed on the beneficiary's income using other than the accumulated income distributed by the trust and a partial tax is to be computed on the accumulated income by using one of the alternative methods. (A partial tax is also to be computed under one of the alternative methods on the distribution of accumulated capital gains where this provision is applicable.) The sum of these partial taxes will be the beneficiary's total tax liability for the year in which he received a distribution of accumulated income. In no event is the partial tax on the accumulation distribution to exceed the amount of the accumulated income distributed.

Since the use of one of the alternative methods of computing the tax on a distribution of accumulated income is required under the Act, the beneficiary must supply such information regarding his income for each of the years in which an amount is considered distributed, as the Secretary or his delegate requires by regulations.

If adequate information regarding the trust is not available to determine the amounts deemed distributed in any preceding taxable years, then all accumulated income of the trust for such years will be considered as distributed during the earliest year upon which it can be shown to the satisfaction of the Secretary or his delegate that the trust was first in existence.

The trust will continue to be taxed, as under prior law, when the income is earned, and subsequently, when the beneficiary is taxed on the income at the time of distribution, he will be able to claim credits for the taxes previously paid by the trust on this income. The Act, however, changes the method for allowing a credit to the beneficiary for taxes paid by the trust where the accumulation distribution deemed made for a previous year is less than the undistributed net income of that year. The Act provides that the credit allowed to the beneficiary for taxes paid by the trust is to be the same amount as the taxes deemed distributed to the beneficiary. This means, as under prior law, that when all of the undistributed net income of a preceding taxable year of the trust is deemed distributed, then all of the taxes paid by the trust with respect to this income (excluding that attributable to the capital gains) will be allowed as a credit to the beneficiary. However, when less than all of the undistributed net income of a preceding taxable year is deemed distributed, then the credit allowable to

the beneficiary is the same as the taxes deemed distributed to the beneficiary, which is the pro rata portion of the taxes imposed on the trust with respect to such income. This change from prior law (which allowed a credit in the amount of taxes the trust would not have paid had the amount deemed distributed actually been paid out in the earlier year) provides for considerable simplification by eliminating the technical complexity required by separate computations for the credit and taxes deemed distributed.

The Act also provides an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision does not apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their income currently, until the first year they accumulate income. For purposes of this provision, a capital gains distribution is deemed to have been made only when the distribution is greater than all of the accumulated ordinary income. If the trust has no accumulated ordinary income or capital gains, or if the distribution is greater than the ordinary income or capital gain accumulations, then to this extent it is considered a distribution of corpus and no additional tax is imposed.

Capital gains are taken into account separately in determining the additional tax payable by the beneficiary. If the exact method is used to compute the tax, the capital gains distribution is thrown back to the earliest year of the accumulated capital gains to the extent of the undistributed capital gains for that year, and then to each of the succeeding years, in a like manner. If, however, the shortcut method is used, only the years in which there were capital gains are taken into account for purposes of determining the average number of years involved.

Where the tax payments by the trust exceed the aggregate tax due with respect to any year, these payments may offset amounts payable by the same beneficiary with respect to other years. Furthermore, where the taxes paid by the trust are in excess of any amounts that would have been paid by the beneficiary if the income had been distributed currently, then the excess taxes are allowable as a credit to the beneficiary in the taxable year in which the accumulation distribution is required to be included in his gross income. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary, in which case a refund would be available. In the case of a beneficiary who uses the exact method, however, a credit is not allowed for any taxable year of the trust before the beneficiary was born or created (if another trust or a person other than a natural person).

In the case where there is a throwback under the new provisions to the same year for which there was a previous throwback under prior law and a partial credit had been allowed for taxes imposed on the trust under prior law, the new rules will apply. Under the new provision, the starting point for both the taxes deemed distributed and the credit allowed will be the taxes originally imposed on the trust, less the total credits previously allowed. Thus, to the extent the credit previously allowed under prior law exceeded the taxes deemed distributed, the excess will not be deemed distributed to the beneficiary, and the remaining taxes imposed on the trust (the uncredited portion of the original tax) will be deemed distributed and credited to the

beneficiary pro rata as and when the remaining undistributed net income of that year is deemed distributed.

The new rules apply to accumulations in taxable years beginning after December 31, 1968, with respect to distributions made after that date. Income accumulated in prior years, regardless of when distributed, is to continue to be subject to the law in effect at the time the income was accumulated except for the fact that the \$2,000 de minimis exemption is made inapplicable to any distributions after December 31, 1968. This means that for taxable years of a trust beginning after December 31, 1973 (at which time the prior law five-year throwback and the exceptions would not apply to accumulations made before December 31, 1968), the new rules will be in effect for all trusts and will apply to accumulations made only after December 31, 1968. All income and capital gains accumulated prior to this date will be treated as part of the corpus of the trust.

The Act modifies the unlimited throwback computation in determining the years to which the accumulated income relates for accumulations made under the new rules as well as accumulations still subject to the old rules. For purposes of computing the tax when an accumulation distribution is made after 1969, the income is treated "as coming from the earliest years first, to the extent of the accumulated income in those years. (For distributions prior to 1970, the 5-year throwback computation treats the income as coming from the years immediately preceding the distribution.) This change is intended to ease the administrative burden of trust accounting in that all the earlier years will be closed out first so that the trust will not have to go further and further back in making its computations each time it makes an accumulation distribution. Under the new computation rules, the trust will always be coming forward to pick-up years of accumulated income.

The Act also provides that, if the fiduciary of the trust elects, a distribution within the first 65 days of a trust's taxable year will be considered as distributed during the preceding taxable year. This provision is intended to give the trustee time to determine the amount of income earned by the trust and an opportunity to distribute it.

The Act further provides that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision does not apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

Effective date.—These provisions are to apply to accumulations made in taxable years beginning after December 31, 1968. In the case of capital gain distributions, the throwback rules do not apply until 1972 where the person is a beneficiary of only one trust and such trust was in existence on December 31, 1969, or in the case of two such trusts where one is for the lifetime benefit of a surviving spouse. In the case of trust income for the benefit of a spouse, the new provision is to apply only with respect to property transferred in trust after October 9, 1969.

Revenue effect.—The changes made by the Act in the tax treatment of trusts are expected to increase revenue by an estimated \$115 million a year in the long run.

K. MULTIPLE CORPORATIONS

(Sec. 401 of the Act and secs. 1561-1564, 46, 48, and 179 of the code)

Prior law.—The income tax on corporations consists of a normal tax at the rate of 22 percent and a surtax at the rate of 26 percent. However, the first \$25,000 of taxable income is exempt from the surtax, and is therefore taxed at an effective rate of 22 percent instead of 48 percent. The surtax exemption was adopted to benefit small businesses.

Under prior law, large business enterprises were able to receive considerable tax benefits, primarily in the form of multiple surtax exemptions, through the use of multiple corporations. However, to some extent prior law limited the ability of a taxpayer to split his business enterprise into a number of corporations so as to obtain multiple surtax exemptions. It did this by requiring a "controlled group" of corporations either to elect one surtax exemption for the group, or if each member claims a surtax exemption each of the corporations must agree to pay an additional 6 percent tax on the first \$25,000 of its taxable income.¹ This latter alternative generally reduced the tax savings of the surtax exemption from \$6,500 to \$5,000.

A "controlled group" was defined under prior law to include three principal categories of affiliated groups of corporations:

(a) Parent-subsidiary controlled group: One or more chains of corporations connected with a common parent corporation through 80 percent or more stock ownership (determined by voting power or value).

(b) Brother-sister controlled group: Two or more corporations each of whose stock was owned 80 percent or more (by voting power or value) by one individual, estate, or trust.

(c) Combined group: Three or more corporations, each of which was a member of a parent-subsidiary group or a brother-sister group, and one of which was a common parent corporation.

In addition to the surtax exemption, there were other provisions of the prior law designed to aid small businesses, but which were taken advantage of to some degree by large organizations through the use of multiple corporations. These include: (1) the provision which allows a corporation to accumulate \$100,000 of earnings without being subject to the penalty tax on earnings unreasonably accumulated to avoid the dividend tax on shareholders; (2) the life insurance company small business deduction of 10 percent of the company's net investment income (limited to \$25,000 per year); and (3) the provision which allows an additional first year depreciation allowance equal to 20 percent of the cost of the property (limited to \$10,000 per year).

General reasons for change.—Large corporate organizations have been able to obtain substantial benefits from these prior law provisions by dividing income among a number of related corporations. Since these are not in reality "small businesses" it is difficult to see why they should receive tax benefits intended primarily for small business, whether or not they have incorporated the businesses separately for business, as distinct from tax, reasons.

Explanation of provisions.—The Act provides that a group of controlled corporations may have only one each of a series of special pro-

¹ The election to claim multiple surtax exemptions and to pay the additional 6 percent tax generally reduced taxes where the group had a combined income of about \$32,500 or more. Below this figure the allocation of a single surtax generally produced a lower tax.

visions designed to aid small corporations. The most important of these are the surtax exemption and the accumulated earnings credit. For taxable years beginning after December 31, 1974, a controlled group of corporations will be limited to one \$25,000 surtax exemption and one \$100,000 accumulated earnings credit.

The Act provides a 6-year transition period, reducing the additional surtax exemptions in excess of one by one-sixth (or \$4,167) in each of the years 1970 through 1975. The additional \$100,000 accumulated earnings credits are similarly reduced.

During the transition period, the 6 percent additional tax imposed on the first \$25,000 of income of each corporation of a controlled group which claims multiple surtax exemptions continues to apply, but it is imposed only with respect to the amount of each corporation's income subject to the reduced additional surtax exemption.

Under the Act a controlled group of corporations may gradually increase the dividend received deduction allowed members of the group from 85 percent to 100 percent by a phase-in at a rate of 2.5 percent per year. The gradually increasing deduction is allowed even though the group is claiming the additional (but reduced) surtax exemptions during the transition period. This rule phases in the 100 percent dividends received deduction in step with the reduction in the additional surtax exemptions. To avail itself of this provision, a controlled group of corporations must have in effect an election under section 1562(a) to claim multiple surtax exemptions which was made on or before April 22, 1969, and the dividends must be paid out of earnings and profits of a taxable year including a December 31 after 1969 but before 1975.

As under present consolidated return regulations, the Act does not permit preconsolidation losses incurred during the transition period to be carried over and used against the income of other members of the group. The Act, however, allows corporations which had elected multiple surtax exemptions (under section 1562) to shift immediately to the consolidated return basis of reporting (foregoing all of the additional surtax exemptions during the transition period) and to use loss carryovers against income of other members of the group if the group agrees to give up the multiple surtax exemptions it had claimed for the year in which the loss was sustained and all intervening years. To avail itself of this provision, the group must file a consolidated return for the taxable year which includes December 31, 1970.

The Act expands the prior law definition of a brother-sister controlled group—i.e., two or more corporations 80 percent or more of the stock of which is owned (by voting power or value) by one individual, estate, or trust. The expanded definition includes any two or more corporations which are owned 80 percent or more (by voting power or value) by five or fewer persons (individuals, estates, or trusts). The expanded definition also requires these five or fewer persons to own more than 50 percent of each corporation identically. In applying the 50 percent test, for example, a person who owns 70 percent of one corporation and 30 percent of another corporation is treated as owning only 30 percent of each corporation identically. It is only this amount which would be taken into account in applying the 50 percent test.

To eliminate the possibility of avoiding the percentage ownership requirements by transferring stock to a tax-exempt organization which

the taxpayer or related parties control, the Act disregards, for purposes of the percentage ownership test, stock owned by a tax-exempt organization which is controlled by the taxpayer, or related parties.

The Act also places a limitation on the multiple use by controlled groups of corporations of other tax benefits which are designed to aid small businesses. Prior law limits multiple use of these benefits only in the case of an affiliated group of corporations (which, in general, is a parent-subsidiary controlled group). Under the Act, members of all controlled groups of corporations are treated as one taxpayer for purposes of determining the additional first-year depreciation deduction. The investment eligible for the first year additional depreciation deduction is apportioned among the component members of a controlled group in the manner prescribed by regulations. A controlled group also is allowed an investment credit equal only to its aggregate tax liability up to \$25,000 plus 50 percent of the group's tax liability above \$25,000. In addition, the group is allowed an investment credit only with respect to \$50,000 of used property. There are no transition rules with respect to these changes. The \$25,000 and \$50,000 amounts are apportioned among the component members of such group in a manner prescribed by regulations. For purposes of the additional first-year depreciation deduction and the \$50,000 used property limitation under the investment credit, the term "controlled group" has the same meaning assigned to it by section 1563(a), except that a 50 percent, rather than 80 percent, test is used.

A controlled group of corporations also is limited to one \$25,000 life insurance company small business deduction. To ease the transition for the companies subject to this change, the bill provides that the additional small business deductions allowed individual members of a controlled group in excess of one are to be reduced at the same rate as the additional surtax exemptions are reduced in each of the years 1970 through 1975; namely, by one-sixth (\$4,167).

Effective date.—The limitation of controlled groups to one surtax exemption, one accumulated earnings credit and one small business deduction, subject to transition rules, applies to taxable years beginning after December 31, 1974. Transition rules apply to taxable years beginning after December 31, 1969. The changes in the definition of a controlled group apply with respect to taxable years ending on or after December 31, 1970. The exclusion from the control test of stock owned by a tax-exempt organization which is controlled by the taxpayer, or related parties, is effective with respect to taxable years ending on or after December 31, 1970. Likewise, the limitation on multiple tax benefits with respect to the investment credit and the additional first-year depreciation deduction are effective with respect to taxable years ending on or after December 31, 1970.

Revenue effect.—The changes made by the Act to prevent controlled multiple corporations from taking undue advantage of the corporate surtax exemption and other provisions designed to aid small business, increase revenue by an estimated \$25 million in calendar year 1970, \$100 million in 1972, and \$235 million in the long run.

L. CORPORATE MERGERS, ETC.

1. Disallowance of Interest Deduction in Certain Cases (secs. 411 and 415 of the Act and secs. 279 and 385 of the code)

Prior law.—Under existing law, a corporation is allowed to deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity.

General reasons for change.—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although this problem is a long-standing one in the tax laws, it has become of increasing significance in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes.

There are a number of factors which can make the use of debt for corporate acquisition purposes advantageous to the acquiring company, including the fact that the company may deduct the interest on the debt but cannot deduct dividends on stock, especially when the debt has characteristics which made it more like equity than debt. For example, a bond which is convertible into stock tends to be more attractive to the owner since the convertibility feature will allow him to participate in the future growth of the company. Also, debt which is subordinated to other creditors of the corporation is more attractive to the corporation since it does not impair its general credit position.

Although it is possible to substitute debt for equity without a merger, this is much easier to bring about at the time of a merger. This is because, although stockholders ordinarily would not be willing to substitute debt for their stockholdings, they may be willing to do so pursuant to a corporate acquisition where they are exchanging their holdings in one company for debt in another (the acquiring) company.

In summary, in many cases the characteristics of an obligation issued in connection with a corporate acquisition make the interest in the corporation which it represents more nearly like a stockholder's interest than a creditor's interest, although the obligation is labeled as debt.

Explanation of provision.—The Act deals with the problems discussed above by adding two different provisions to the tax laws, one which is of general application under the tax laws and a second which relates only to corporate acquisitions.

The first of these provides the Secretary of the Treasury or his delegate with specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a corporate obligation constitutes stock or indebtedness for all purposes of the Internal Revenue Code. These guidelines are to set forth factors to be taken into account in determining in a particular factual situation whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists. The provision specifies certain factors which may be taken into account in these guidelines. However, it is not intended that only these factors be included in the guidelines or that, in a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other

factors added by regulations. The factors specifically listed are as follows:

- (1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
- (2) Whether there is subordination to, or preference over, any indebtedness of the corporation;
- (3) The ratio of debt to equity of the corporation;
- (4) Whether there is convertibility into the stock of the corporation; and
- (5) The relationship between holdings of stock in the corporation and holdings of the interest in question.

In developing these guidelines, the Secretary of the Treasury is not bound or limited by the specific rules which the Act provides for distinguishing debt from equity in the corporate acquisition context, described below. Thus, an obligation the interest on which is not disallowed under the corporate acquisition section nevertheless might be found to constitute equity (and hence the interest disallowed) under the general debt-equity regulatory guidelines. Moreover, unlike the rules provided by the Act in a corporate acquisition context, which deal only with the allowability of the interest deduction, the guidelines to be promulgated by the Secretary of the Treasury are applicable for all purposes of the Internal Revenue Code.

As previously indicated, the Act also provides a second set of specific rules for determining whether an obligation constitutes debt or equity insofar as the allowability of the interest deduction is concerned in the case of corporate acquisitions. Where three tests apply a corporation is not allowed an interest deduction (either for stated interest or unstated interest such as original issue discount) for indebtedness which it issues as consideration for the acquisition of stock in another corporation, or for the acquisition of assets of another corporation.¹ In the case of an asset acquisition, however, the interest disallowance rule applies only if at least two-thirds of the value of the assets (other than money) of a company which are used in trades or businesses carried on by it, are acquired in a plan of acquisition.²

The limitation on the interest deduction applies to debt obligations which meet each of three tests, namely, the subordination test, the convertibility test and the debt equity or interest coverage test.

The subordination test applies if the obligation either is subordinated to the claims of trade creditors of the issuing corporation generally, or if it is expressly subordinated to any substantial amount of the corporation's unsecured indebtedness (whether outstanding or subsequently issued). An obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself or in a side agreement and whether the subordination relates to interest or principal or both. However, an obligation is not considered subordinated if the subordination occurs solely by operation of law, as in the case of bankruptcy laws.

¹ Indebtedness as used here means any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by the corporation.

² An asset which will be considered as used in a corporation's trade or business retains this status even though it is temporarily not actually used in the business.

The convertibility test applies if the obligation either is directly or indirectly convertible into the stock of the issuing corporation or the obligation is a part of an investment unit or other arrangement which includes an option to acquire, directly or indirectly, stock of the issuing corporation. Thus, the convertibility test applies, for example, if warrants to purchase the stock of the corporation are issued in conjunction with the obligation.

The debt-equity and interest limits apply to an obligation either if the debt-equity ratio of the issuing corporation is in excess of 2 to 1 or if the annual interest expense to be paid by the issuing corporation on its total indebtedness is not covered at least three times over by its projected earnings.³ The debt-equity ratio of the issuing corporation generally is determined by comparing the corporation's total indebtedness with the excess of its money and other assets over that indebtedness. Its assets are taken into account for this purpose at their adjusted basis for purposes of determining gain.

The annual interest limit of the third test generally is applied by comparing the average annual earnings of the issuing corporation for the 3-year period ending with the last day of the taxable year for which the determination is being made with the corporation's annual interest costs on its total indebtedness as of the time of determination. For this purpose, the average annual earnings, generally, means the corporation's earnings and profits computed without reduction for interest, depreciation or amortization, Federal income tax liability or dividends paid (other than dividends paid from the acquired to the acquiring corporation).⁴

Specific rules are provided for purposes of applying the debt-equity and interest tests in the case of banks and corporations primarily engaged in a lending or finance business.⁵ In determining the debt-equity ratio of a bank or lending or finance company, the Act provides that its total indebtedness is reduced by the total amount of indebtedness owed to it which arises out of the banking business or the lending or finance business. The assets of the bank or company also are reduced by this amount since a company's equity is defined in terms of the excess of its assets over its indebtedness.

In determining the annual interest expense of a bank or a lending or finance company, the Act, in effect, also provides that the interest expense on its indebtedness which is used in the banking or the lending or finance business is not taken into account. The amount of its interest expense not taken into account for this purpose is that part of the corporation's total interest expense which is proportionate to that part of its total indebtedness which is not taken into account for purposes

³ These tests generally are applied as of the last day of a taxable year in which an obligation is issued for the specified acquisition purposes.

⁴ Where the issuing corporation has either acquired control (as defined for purposes of the reorganization provisions of the code) of the acquired company or has acquired substantially all of the properties of the acquired company, then the annual interest test is determined with respect to the average annual earnings and the annual interest cost of both corporations combined.

⁵ For this purpose, a lending or finance business means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations.

of the debt-equity test. A similar reduction is made in determining its projected earnings.⁶

A number of exceptions or modifications are provided to the interest disallowance rule as set forth above. First, an interest deduction for up to \$5 million per year of interest costs is not disallowed under this provision with respect to obligations issued for the specified acquisition purposes, even though the three tests for disallowance of the deduction apply. This \$5 million exception for any year, however, is reduced for any interest paid by the issuing corporation on obligations issued after 1967 for the specified acquisition purposes which were not subject to the disallowance rule.⁷

Second, the interest deduction disallowance may be modified by subsequent actions. The Act provides that the interest deduction for obligations issued for the specified acquisition purposes which meet all three tests is disallowed starting with the first taxable year of the corporation as of the last day of which the debt-equity or annual interest coverage test applies. As a general rule, once the tests prescribed by the Act apply with respect to an obligation, the interest deduction will be disallowed for all subsequent taxable years. Where, however, the issuing corporation subsequently obtains control of, or acquires substantially all the properties of, another corporation, and, as a result, by applying the debt-equity or annual interest coverage test as of the end of the year in which control, or the properties, are acquired and by taking the annual interest expense and projected earnings of both corporations into account for purposes of the annual interest coverage alternative of the test, the limits provided in the test are no longer exceeded, then the interest deduction is allowed for that taxable year and subsequent taxable years.

In addition, the Act makes provision for a corporation to have the interest deduction restored with respect to obligations it issued where its capital structure has been improved so that the debt-equity and interest coverage tests are satisfied for a substantial period of time. It provides that if an issuing corporation has the appropriate

⁶ These rules regarding the application of the debt-equity and interest coverage tests also apply if the bank or the lending or finance company is a member of an affiliated group of corporations (whether or not it is the issuing corporation). In this case, however, the rules are applied only for purposes of determining the debt, equity, interest expense, and projected earnings of the bank or lending or finance company which then are taken into account in determining the debt-equity ratio and annual interest coverage of the affiliated group as a whole. In other words, these rules are applied to reduce the bank's or the lending or finance company's debt, interest expense, and projected earnings which are taken into account with respect to the group, but are not to reduce the debt, interest expense or projected earnings of other corporations in the affiliated group.

In determining whether a company which is a member of an affiliated group is "primarily engaged in a lending or finance business," only the activities of the company—not those of the whole group—are taken into account. The above principles also are applied in cases where the projected earnings and annual interest expense of both the issuing corporation and the acquired corporation are taken into account for purposes of the interest coverage test.

⁷ Obligations issued for the specified acquisition purposes after 1967 but before October 10, 1969, are included within the category of obligations which cause a reduction in the \$5 million exception, whether or not these obligations meet the three specific tests, since the disallowance rule only applies to obligations issued after October 9, 1969. The term "issued" includes the giving of a note to a bank or other lender as well as the issuance of a bond or debenture. In addition, as is generally provided for purposes of the disallowance rule, the extension, renewal, or refinancing of an obligation is not considered the issuance of a new obligation. Thus, the interest on an obligation issued to refinance a pre-1968 obligation used for corporate acquisition purposes is not taken into account as a reduction of the \$5 million exception.

In the case of obligations issued for the specified acquisition purposes after October 9, 1969, the \$5 million exception is reduced by the interest on any obligation which is not subject to the disallowance rule. Included within this category are obligations which do not meet one of the three specified tests; obligations used to acquire foreign corporations; obligations which are no longer subject to the disallowance rule because of the special 3-year rule discussed below; and obligations which qualify for the 5 percent stock rule discussed below. Also included within this category are obligations issued under the transition rules discussed below.

debt-equity ratio and interest coverage for each of three consecutive taxable years, then the disallowance rule ceases to apply to previously issued obligations beginning with the first taxable year after the three-year period.

Third, the interest disallowance rule does not apply with respect to tax-free acquisitions of stock of a newly formed subsidiary or of stock of an existing subsidiary (i.e., a corporation which the issuing corporation theretofore controlled within the meaning of section 368(c)).

Fourth, an exception also is provided to the interest deduction disallowance rule for indebtedness issued in connection with the acquisition of assets or stock of a foreign corporation, if substantially all of the income of the foreign corporation for the 3 years prior to the acquisition was from foreign sources.

Fifth, in order to eliminate de minimis stock acquisitions from the scope of the disallowance rule, the Act provides that this rule applies to obligations issued to acquire stock in a company, only if the issuing corporation has owned 5 percent or more of the total combined voting power of the other corporation at any time between October 9, 1969, and the close of the taxable year in which the stock acquisition occurs.

Sixth, where the issuing corporation is a member of an affiliated group (as determined under section 1504(a) without any exclusion under section 1504(b)), the various tests set forth above are in general applied by treating all members of the affiliated group as one entity, i.e., by treating the group as the issuing corporation. The company whose stock is being acquired, however, is not treated as a member of the affiliated group (even if it otherwise would be considered a member of the group) and thus an acquisition of its stock (including stock held by a minority shareholder) is subject to the interest deduction disallowance rule.

Seventh, the extension, renewal, or refinancing of an existing obligation is not considered the issuance of a new obligation. Thus, if the interest deduction is disallowed with respect to an obligation, the disallowance continues even though the obligation is extended, renewed, or refinanced. In addition, the interest deduction disallowance rule continues to apply if a corporation, other than the issuing corporation, becomes liable on an obligation as guarantor, endorser, or indemnitor, or assumes liability for the obligation.

For purposes of applying other provisions of the Internal Revenue Code, the Act provides that no inference is to be drawn from these rules as to whether any obligation which the issuer terms a bond, debenture, note, certificate or other evidence of indebtedness is, in fact, indebtedness of the issuer.

Effective date.—This provision applies to interest paid or incurred with respect to indebtedness incurred after October 9, 1969. The Act provides that this provision is inapplicable, even though an obligation is issued after October 9, 1969, in two types of transition situations where the transaction had previously been undertaken. First, the provision is not applicable to obligations issued to acquire stock or assets of a corporation pursuant to a binding contract in effect on October 9, 1969.

Second, where the issuing corporation as of October 9, 1969, had at least a 50 percent voting interest in another corporation, this provision is not applicable to the obligations issued by the corporation to

acquire the additional stock in the other corporation which is necessary to give the acquiring corporation control (i.e., an 80 percent interest) of the other corporation, but only to that extent. If obligations are issued to acquire a greater amount of stock than is necessary for this purpose, only the proportionate part of the obligations related to the acquisition of that part of the stock acquired which is necessary to provide control is eligible for this treatment. This will allow a corporation which had achieved practical control of another corporation by October 9, 1969, to acquire the additional stock necessary to give it control for tax purposes.

2. Limitation on Installment Sales Provision (sec. 412 of the Act and sec. 453(b) of the code)

Prior law.—Under existing law, a taxpayer may elect the installment method of reporting a gain on a sale of real property, or a casual sale of personal property where the price is in excess of \$1,000. The installment method, however, was available under prior law only if the payments received by the seller in the year of sale (not counting debt obligations of the purchaser) did not exceed 30 percent of the sales price.

Although the Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures of the purchaser, it is understood that some tax counsel have advised that the method was so available.

General reasons for change.—The allowance of the installment method of reporting where readily marketable debentures or securities are received by the seller of property is not consistent with the purpose for which the installment provision was adopted. This method presumably was initially made available because of the view that where a seller received a debt obligation he did not have cash, or the equivalent of cash, on hand which would provide him with funds to pay the tax due on the gain. This problem, however, does not exist where the seller receives readily marketable securities.

Explanation of provision.—The Act provides that for purposes of the installment method of reporting gains on sales of real property and casual sales of personal property, certain types of indebtedness are treated as payments received in the year of sale. As a result, these types of bonds or debentures constitute income to the seller in the year of sale and also are taken into account for purposes of the requirement which denies use of the installment method where more than 30 percent of the sales price is received in the year of sale.

The type of indebtedness treated in this manner are bonds or debentures issued by any person and payable on demand, and corporate or government bonds with interest coupons attached, in registered form, or in any other form designed to make it possible to readily trade them in an established securities market. Bonds or debentures are considered designed to be readily tradeable if steps necessary to create a market for the security are taken at the time of issuance or if the bonds or debentures are part of an issue which will normally be traded through brokers dealing in corporate or government securities.⁸

On the other hand, bonds in registered form which the taxpayer establishes will not be readily tradeable in an established securities

⁸ Also covered are bonds and debentures where a market is created after issuance if this is done under an agreement or understanding which existed at the time of issuance.

market are not treated as payments received in the year of sale, since they do not possess the characteristics which would render them essentially similar to cash.

A bond or debenture ordinarily is considered in registered form if it is issued in a series under a trust indenture and if it cannot be transferred without changing the ownership registration on the registration books of the corporation. It is not intended that ordinary promissory notes are to be included within the category of indebtedness which is treated as payments received in the year of sale, even though it is possible for these notes to be assigned by one party to another party.

The rationale for this provision essentially is that there is no reason for postponing the gain where a seller of property receives something which is the equivalent of cash. Therefore, although the problem to which this provision is directed has been highlighted by the debentures issued in connection with corporate acquisitions, this provision is not restricted in application to these situations.

Effective date.—This provision applies with respect to sales or other dispositions occurring after May 27, 1969, except where the sale or disposition is made pursuant to a binding contract entered into on or before that date.

3. Original Issue Discount (sec. 413 of the Act and sec. 1232 of the code)

Prior law.—Prior law provided that original issue discount arises where a corporation issues a bond (debenture, note, certificate, or other evidence of indebtedness) for a price less than the face amount of the bond, if the bond is a capital asset in the hands of the person acquiring it. The amount of the original issue discount is the difference between the face value of the bond (its stated redemption value) and the issue price. The owner of the bond was not taxed on the original issue discount until the bond was redeemed, if he held it until maturity, or until he sold or otherwise disposed of the bond in a taxable transaction. In this latter case, only that portion of the gain realized by the owner of the bond on its sale which was equal to the part of the original issue discount attributable to the period he held the bond was taxed at ordinary income rates. The remainder of the gain was treated as capital gain.

The issuing corporation, on the other hand, amortizes the amount of the original issue discount over the life of the bond. In other words, it is allowed a current interest deduction with regard to the original issue discount.

General reasons for change.—Prior law resulted in a nonparallel treatment of original issue discount between the issuing corporation and the bondholder. The corporation deducted a part of the discount each year. On the other hand, the bondholder was not required to report any of the discount as income until he disposed of the bond. Although it is likely that the discount was deducted by the corporation, it is probable that under prior law much of the ordinary income was not being reported by the bondholders.

Explanation of provision.—In general, the Act provides that the bondholder and the corporation issuing the bond are to be treated in a consistent manner with respect to the original issue discount on the

bond. The bondholder is required to include the original issue discount in his income on a ratable basis over the life of the bond. As he includes the original issue discount in income, his basis for the bond is correspondingly increased.

If a bondholder sells the bond prior to maturity (or it is redeemed), he is treated as receiving capital gain based on his adjusted basis for the bond (taking into account the previous adjustments for the amount of original issue discount he had included in income), unless when the bond was originally issued there was an intention to call it before its maturity. In the latter case, the gain on the sale (or redemption) of the bond is treated as ordinary income to the extent of the amount of original issue discount, less any amount of the original issue discount previously taxed to the bondholder or a prior bondholder.

The purchaser of a bond is treated as standing in the place of the first owner so that the balance of the original issue discount, which had not been included in gross income by the first owner, generally is included in income by the second owner ratably over the remaining life of the bond. Where the second owner purchases a bond for an amount above the first owner's adjusted basis for the bond, the second owner is allowed to deduct this excess ratably over the remaining life of the bond from the original issue discount he otherwise would be required to include in income.

The ratable inclusion of original issue discount in income is not required of persons who purchased a bond at a premium.

The Act also excludes from the scope of the ratable inclusion requirement life insurance companies which under existing law must accrue original issue discount yearly either under a ratable method or under a method the company regularly employs, if the method is reasonable.

To facilitate the proper reporting of original issue discount and to facilitate the Internal Revenue Service's administration of this provision, a corporation issuing a bond in registered form is required to furnish the owner of the bond and the Government with an annual information return showing the amount of original issue discount includable in the bondholder's income for the year.

If a bond is issued for property, original issue discount does not arise except where the bond is part of an issue a portion of which is traded on an established securities market, or where the bond is issued solely for stock or securities which are traded on an established securities market. In these situations the issue price of the bond is the fair market value of the property. Original issue discount does not arise in any case where bonds are issued for property pursuant to a plan of tax free reorganization or an insolvency reorganization.

In determining whether there is original issue discount, in the case where bonds are issued with warrants, the issue price of each element of the investment unit must be allocated between the elements of the investment unit on the basis of their respective fair market values.

The rules provided by the Act regarding the treatment of original issue discount do not apply to bonds or other evidences of indebtedness issued by any government or political subdivision (or to bonds or other evidences of indebtedness issued by a corporation on or before May 27, 1969). In these cases, the rules of prior law regarding the treatment of original issue discount on the sale or exchange of a bond which is a

capital asset and which has been held for more than 6 months continue to apply. In addition, in these cases gain on the sale or exchange of a bond which is a capital asset but which has not been held for more than 6 months is treated as a short-term capital gain as under prior law.

Effective date.—This provision applies to bonds and other evidences of indebtedness issued after May 27, 1969, except where the indebtedness is issued pursuant to a binding commitment entered into prior to May 28, 1969.

4. Convertible Indebtedness Repurchase Premiums (sec. 414 of the Act and sec. 249 of the code)

Prior law.—Under prior law, there was a question as to whether a corporation which repurchased its convertible indebtedness at a premium could deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There are, however, court cases which hold to the contrary and allow the deduction of the entire premium. In addition, other court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

General reasons for change.—A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, the Congress believed that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner.

Explanation of provision.—In the case of premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock (or the stock of a controlling or controlled corporation), the Act provides that the amount of the premium which may be deducted is limited to an amount not in excess of a normal call premium for nonconvertible corporate indebtedness. The amount of the premium paid by the corporation upon the repurchase is considered to be the excess of the amount paid over the issue price of the indebtedness (plus any amount of discount previously deducted and minus any amount of premium previously reported as income).

A larger deduction may be allowed with respect to the premium, however, where the corporation can demonstrate to the satisfaction of the Secretary or his delegate that the amount of the premium in excess of that otherwise allowed as a deduction is related to the cost of borrowing and is not attributable to the conversion feature of the indebtedness. This exception is designed to allow for changes in interest rates and to permit market and credit conditions to be taken into account.

Effective date.—This provision applies with respect to repurchases of convertible indebtedness after April 22, 1969, unless the repurchase is pursuant to a binding obligation incurred on or before that date to repurchase at a specified call premium. The Act provides that in such

a case no inference is to be drawn as to the deductibility of that portion of the premium which is attributable to the conversion feature from the fact that this provision does not apply to that convertible indebtedness. The Congress further intends that no inference is to be drawn as to the proper treatment under prior law of a premium paid by a corporation on the repurchase of its convertible indebtedness either from the enactment of this provision or from the fact that this provision does not apply to repurchases of indebtedness prior to April 23, 1969.

5. Revenue Effect

These provisions relating to the disallowance of interest deductions in certain corporate mergers, the limitation on the installment sale provision, original issue discount and premiums for the repurchase of convertible indebtedness taken together, are estimated to increase revenue \$5 million in calendar year 1970, \$15 million in 1972 and \$40 million in the long run.

M. STOCK DIVIDENDS

(Sec. 421 of the Act and secs. 301 and 305 of the code)

Prior law.—In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and its stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash.

Prior law provided that generally if a corporation paid a dividend to its shareholders in its own stock (or in rights to acquire its stock), the shareholders were not required to include the value of the dividend in income. There were two important exceptions to the general rule, however. First, stock dividends paid in discharge of preference dividends for the current or immediately preceding taxable year were taxable. Second, a stock dividend was taxable if any shareholder could elect to receive his dividend in cash or other property instead of stock.

These provisions were enacted as part of the Internal Revenue Code of 1954. Before 1954 the taxability of stock dividends was determined under the "proportionate interest test," which developed out of a series of Supreme Court cases, beginning with *Eisner v. Macomber*, 252 U.S. 189 (1920). In these cases the Court held, in general, that a stock dividend was taxable if it increased any shareholder's proportionate interest in the corporation. The lower courts often had

difficulty in applying the test as formulated in these cases, particularly where unusual corporate capital structures were involved.

Soon after the proportionate interest test was eliminated in the 1954 Code, corporations began to develop methods by which shareholders could, in effect, be given a choice between receiving cash dividends or increasing their proportionate interests in the corporation in much the same way as if they had received cash dividends and reinvested them in the corporation. The earliest of these methods involves dividing the common stock of the corporation into two classes, A and B. The two classes share equally in earnings and profits and in assets on liquidation. The only difference is that the class A stock pays only stock dividends and the class B stock pays only cash dividends. The market value of the stock dividends paid on the Class A stock is equated annually to the cash dividend paid on the class B stock. Class A stock may be converted into class B stock at any time. The stockholders can choose whether to own class A stock or class B stock when the classes are established, when they purchase new stock, or through the convertibility option.

In 1956, the Treasury Department issued proposed regulations which treated such arrangements as taxable distributions subject to an election by the stockholder to receive cash instead of stock. In recent years, however, increasingly complex and sophisticated variations of this basic arrangement have been created. In some of these arrangements, the proportionate interest of one class of shareholders is increased even though no actual distribution of stock is made. This effect may be achieved, for example, by paying cash dividends on common stock and increasing by a corresponding amount the ratio at which convertible preferred stock or convertible debentures may be converted into common stock. Another method of achieving this result is a systematic periodic redemption plan, under which a small percentage, such as 5 percent, of each shareholder's stock may be redeemed annually at his election. Shareholders who do not choose to have their stock redeemed automatically increase their proportionate interest in the corporation.

On January 10, 1969, the Internal Revenue Service issued final regulations (T.D. 6990) under which a number of methods of achieving the effect of a cash dividend to some shareholders and a corresponding increase in the proportionate interest of other shareholders were brought under the exceptions in section 305(b), with the result that shareholders who receive increases in proportionate interest were treated as receiving taxable distributions.

General reasons for change.—Questions have been raised as to the statutory basis for the final regulations. In any case, they did not cover all of the arrangements by which cash dividends could be paid to some shareholders and other shareholders could be given corresponding increases in proportionate interest. For example, the periodic redemption plan described above was not covered by these regulations.

Methods had also been devised to give preferred stockholders the equivalent of dividends on preferred stock which were not taxable as such under prior law. For example, a corporation could issue preferred stock for \$100 per share which paid no dividends, but which would be redeemed in 20 years for \$200. The effect is the same as if the corporation distributed preferred stock equal to 5 percent of the original stock each year during the 20-year period in lieu of cash dividends.

Congress concluded that dividends paid on preferred stock should be taxed whether they are received in cash or in another form, such as stock, rights to receive stock, or rights to receive an increased amount on redemption, and that dividends on preferred stock should be taxed to the recipients whether they are attributable to the current or immediately preceding taxable year or to earlier taxable years.

Explanation of provisions.—The Act continues (in sec. 305(b)(1)) the provision of present law that a stock dividend is taxable if it is payable at the election of any shareholder in property instead of stock.

The Act also provides a series of rules to be used in determining when various transactions are to result in amounts being treated as dividends.

First, the Act provides (in sec. 305(b)(2)) that if there is a distribution or series of distributions of stock which has the result of the receipt of cash or other property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation, the shareholders receiving stock are to be taxable (under sec. 301). For example, if a corporation has two classes of common stock, one paying regular cash dividends and the other paying corresponding stock dividends (whether in common or preferred stock), the stock dividends are taxable.

On the other hand, if a corporation has a single class of common stock and a class of preferred stock which pays cash dividends and is not convertible, and it distributes a pro rata common stock dividend with respect to its common stock, the stock distribution is not taxable because the distribution does not have the result of increasing the proportionate interests of any of the stockholders.

In determining whether there is a disproportionate distribution, any security convertible into stock or any right to acquire stock is treated as outstanding stock. For example, if a corporation has common stock and convertible debentures outstanding, and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution, and the stock dividends are taxable. In addition, in determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock is considered separately.

Second, the Act provides (in sec. 305(b)(3)) that if a distribution or series of distributions has the result of the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, all of the shareholders are taxable on the receipt of the stock.

Third, the Act provides (in sec. 305(b)(4)) that distributions of stock with respect to preferred stock are taxable. This provision applies to all distributions on preferred stock except increases in the conversion ratio of convertible preferred stock made solely to take account of stock dividends or stock splits with respect to the stock into which the convertible stock is convertible.

Fourth, the Act provides (in section 305(b)(5)) that a distribution of convertible preferred stock is taxable unless it is established to the satisfaction of the Secretary or his delegate that it will not have the result of a disproportionate distribution described above. For example, if a corporation makes a pro rata distribution on its common stock of preferred stock convertible into common stock at a price slightly higher

than the market price of the common stock on the date of distribution, and the period during which the stock must be converted is 4 months, it is likely that the distribution would have the effect of a disproportionate distribution. Those stockholders who wish to increase their interests in the corporation would convert their stock into common stock at the end of the 4-month period, and those stockholders who wish to receive cash would sell their stock or have it redeemed. On the other hand, if the stock were convertible for a period of 20 years from the date of issuance, there would be a likelihood that substantially all of the stock would be converted into common stock, and there would be no change in the proportionate interest of the common shareholders.

Fifth, the Act provides (in sec. 305(c)) that under regulations prescribed by the Secretary or his delegate, a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption treated as a section 301 distribution, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder is to be treated as a distribution with respect to each shareholder whose proportionate interest is thereby increased. The purpose of this provision is to give the Secretary authority to deal with transactions that have the effect of distributions, but in which stock is not actually distributed.

The proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by such methods as increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock, by decreasing the ratio at which other stock, convertible securities, or rights to stock can be converted into stock of the class he owns, or by the periodic redemption of stock owned by other shareholders. It was not clear under prior law to what extent increases of this kind would be considered distributions of stock or rights to stock. In order to eliminate uncertainty, the Act authorizes the Secretary or his delegate to prescribe regulations governing the extent to which such transactions shall be treated as taxable distributions.

For example, if a corporation has a single class of common stock which pays no dividends and a class of preferred stock which pays regular cash dividends, and which is convertible into the common stock at a conversion ratio that decreases each year to adjust for the payment of the cash dividends on the preferred stock, it is anticipated that the regulations will provide in appropriate circumstances that the holders of the common stock will be treated as receiving stock in a disproportionate distribution (under sec. 305(b)(2)).

It is anticipated that the regulations will establish rules for determining when and to what extent the automatic increase in proportionate interest accruing to stockholders as a result of redemptions under a periodic redemption plan are to be treated as taxable distributions. A periodic redemption plan may exist, for example, where a corporation agrees to redeem a small percentage of each common shareholder's stock annually at the election of the shareholder. The shareholders whose stock is redeemed receive cash, and the shareholders whose stock is not redeemed receive an automatic increase in their proportionate interests. However, it is not intended that this regulatory authority be used to bring isolated redemptions of stock under the disproportionate distribution rule (of sec. 305(b)(2)). For ex-

ample, a 30 percent stockholder would not be treated as receiving a constructive dividend because a 70 percent stockholder causes a corporation to redeem 15 percent of its stock from him.

The provision giving the Secretary authority to treat certain transactions as distributions (sec. 305(c)) also applies to distributions on preferred stock. For example, assume that a corporation issues preferred stock convertible into its common stock, and that the preferred stock pays no cash dividends, but the ratio at which it may be converted into common stock increases annually by a specified percentage. It is anticipated that the regulations will provide that the change in conversion ratio in such a case constitutes a taxable distribution of a right to acquire stock. Similarly, a corporation may issue preferred stock which pays no cash dividends, but which may be redeemed after a specified period of time at a price higher than the issue price. It is anticipated that, unless the increase is a reasonable call premium, it will be treated under the regulations as constructively received by the stockholder over the period during which the preferred stock cannot be called for redemption.

It is also anticipated that the regulations will provide that if preferred stockholders are given stock in a recapitalization, or an increase in proportionate interest by means of a constructive distribution, as payment of current dividends or dividend arrearages, sec. 305(b)(4) is to apply whether or not the recapitalization or other transaction is an isolated transaction. Thus, if in a recapitalization preferred stockholders are given additional preferred stock in satisfaction of several years' dividend arrearages, the distribution of the additional stock will be taxable.

This provision (sec. 305) is not intended to affect the characterization of a nonprorata distribution (or deemed distribution) as a gift, compensation, adjustment of purchase price, etc. For example, a nonprorata distribution on common stock may have the effect of a gift to the recipient by the other stockholders.

Effective date.—This provision applies to distributions (or deemed distributions) made after January 10, 1969, in taxable years ending after that date.

A transitional rule is provided under which the disproportionate distribution rule does not apply to certain distributions made by a limited number of corporations before January 1, 1991. The transitional rule applies to distributions with respect to—

- (a) stock outstanding on January 10, 1969;
- (b) stock issued pursuant to a contract binding on January 10, 1969;¹
- (c) additional stock of the class having the largest fair market value (measured by including stock outstanding on January 10, 1969, including stock issued pursuant to a contract binding on that date);
- (d) preferred stock convertible into the class of stock referred to in (c), if it has full antidilution protection; and
- (e) stock issued in prior distributions to which the transitional rule applies.

¹ A contract is considered binding on the distributing corporation on January 10, 1969, if it is binding on the management of the distributing corporation on that date, even though necessary stockholder approval is obtained later.

The transitional rule does not apply unless both the class of stock paying stock dividends and the class paying cash dividends were outstanding on January 10, 1969, or were created pursuant to a contract binding on that date. If both classes of stock were also outstanding on January 10, 1968, the transitional rule applies only if the corporation actually made a distribution on each class on or before January 10, 1969.

The transitional rule ceases to apply if at any time after October 9, 1969, the corporation issues any stock (other than in a distribution with respect to stock of the same class) which is not—

- (a) nonconvertible preferred stock;
- (b) additional stock of the class of stock having the largest fair market value of the classes of stock subject to the transitional rule;
- (c) preferred stock convertible into the class of stock referred to in (b), if it has full antidilution protection.

The Act also provides a transitional rule under which distributions (or deemed distributions) with respect to preferred stock made before January 1, 1991, will not be taxable if they are made pursuant to the terms relating to its issuance which were in effect on January 10, 1969.

The Congress understands that the September 7, 1968, date in the transitional rule of the regulations will be changed to January 10, 1969, so that there will not be a gap between the transitional rule of the regulations and the transitional rule of the bill.

In cases to which Treasury Decision 6990 would not have applied, April 22, 1969, is substituted for January 10, 1969, for purposes of the effective date and the transitional rules.

Revenue effect.—The amendment will not have any immediate revenue impact. However, if the law were to permit the tax-free distribution of stock dividends on part of the common stock while cash is distributed on the remaining common stock, the revenue loss would be very substantial because it is probable that many publicly held corporations would adopt a capital structure with two classes of common stock so that their stock could be sold both to investors desiring appreciation and to investors desiring a current income. The amendment makes all transactions having this effect taxable and thus makes certain that a substantial revenue loss will not occur.

N. FINANCIAL INSTITUTIONS

1. Commercial Banks—Reserve for Losses on Loans (secs. 431 of the Act and sec. 585 of the code)

Prior law.—Commercial banks were permitted, by administrative rulings, more generous bad-debt reserves than most taxpayers. To protect banks against possible catastrophic losses, the Treasury Department in 1947 permitted a bank to accumulate a reserve not exceeding three times the moving average of its annual percentage loss during the last 20 years. This was changed in 1954 to allow banks to determine their average loss experience on the basis of any 20 consecutive years after 1927. In 1965, Revenue Ruling 65-92 (C.B. 1965-1, 112) granted commercial banks on an industry-wide basis the privilege of

building up a bad-debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. The 2.4-percent figure used for this purpose was roughly three times the annual bad-debt loss of commercial banks during the period 1928-47. In 1968, Revenue Ruling 68-630 (C.B. 1968-2, 84) clarified the loan base used for computing the allowable bad-debt reserve to include only those loans on which banks can suffer an economic loss.

General reasons for change.—By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, prior law gave them more favorable treatment than most other taxpayers. The Internal Revenue Code (sec. 166(c)) permits business taxpayers to take a deduction for a reasonable addition to a reserve for bad debts. Most businesses as a result of this provision accumulate a bad-debt reserve equal to the ratio of the average year's losses to accounts receivable. The average year's loss is computed on the basis of losses for the current year and the 5 preceding years.

Commercial banks have the option of establishing their bad-debt reserves on the basis of their actual experience like other taxpayers. However, under prior law they generally elected to build up these reserves on the basis of the industry-wide 2.4-percent figure permitted by Revenue Ruling 65-92. On the basis of their own experience in the last six years, banks would on the average be allowed to build up a bad-debt reserve of about 0.2 percent of outstanding noninsured loans. The Congress sees no reason why in the long run financial institutions should be treated any more favorably than other taxpayers in building up bad debt reserves.

Explanation of provision.—The Act gradually reduces the allowable deductions for additions to bad debt reserves of commercial banks in order to eliminate the special advantage that they had over other taxpayers under prior law with regard to such reserves. Instead of being allowed to build up their bad debt reserves to 2.4 percent of eligible outstanding loans as under prior law, commercial banks will be permitted to build up these reserves only—

to 1.8 percent of such loans for taxable years beginning after July 11, 1969 and before 1976;

to 1.2 percent of eligible loans for taxable years beginning after 1975 and before 1982; and

to 0.6 percent of eligible loans for taxable years beginning after 1981 and before 1988.

For taxable years beginning after 1987, the percentage method will be withdrawn completely and commercial banks will be required to base their deductions for additions to bad debt reserves on their actual losses for the current and five preceding years, following the procedure generally used by other taxpayers. During the transition period in which the percentage method continues to apply, commercial banks will continue to have the option of taking deductions for additions for bad-debt reserves on the basis of their actual loss experience.

Commercial banks with bad-debt reserves, which exceed the specified allowable percentage of eligible loans at any of the times the allowable

percentage figures are reduced,¹ are not required to reduce the dollar amount of existing reserves, although of course they cannot build a reserve above the allowable percentage. At a minimum, banks whose level of eligible loans does not decrease are allowed to deduct their actual bad debt losses during the year (i.e., the losses will be charged against the bad-debt reserve, thereby reducing the level of it, and the bank may then deduct an addition to the reserve necessary to increase it to its prior level). They are also permitted to increase reserves if the increase is justified on the basis of their actual loss experience.

On the other hand, commercial banks whose bad-debt reserves are below the level permitted in a year prior to one in which the allowable percentage figure is reduced are allowed to bring their reserves up to this dollar level over the next 5 years if the permitted dollar level of the reserves in those years does not drop below that which existed in that prior year.² The addition to bad-debt reserves in any particular year, however, cannot exceed 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve to 0.6 percent of eligible loans outstanding at the close of the taxable year, whichever is greater.

The Act provides that the Secretary or his delegate is to prescribe regulations necessary to carry out the purposes of the provision in-

¹ The years at the end of which the allowable percentage is reduced are called "base years." The base years are as follows:

For taxable years beginning before 1976, the base-period year is the last taxable year beginning on or before July 11, 1969;

For taxable years beginning after 1975 but before 1982, the base-period year is the last taxable year beginning before 1976;

For taxable years beginning after 1981, the base-period year is the last taxable year beginning before 1982.

For many banks, only the first base-period year is likely to be significant, namely, that before July 11, 1969. Thus, for many banks, if they have a stated dollar amount in a reserve in a year beginning before July 11, 1969, their reserve in subsequent years may be maintained at this dollar amount if the amount of their eligible loans does not decrease. However, situations arise where this dollar floor on the reserve may be lowered or raised.

First, in some subsequent year, the volume of loans might be smaller than in the year beginning before July 11, 1969. In that case the dollar floor on the reserve would be reduced for that subsequent year. The reduced level would be the base year reserve percentage (i.e., the actual percentage which the taxpayer's bad-debt reserve in the base year was of its eligible loans at that time) of the reduced amount of eligible loans for the subsequent year. If the reduced dollar floor on the reserve resulted in a decrease in the actual level of the reserve which continued into a subsequent base year (i.e., generally, 1975 and 1981), then a new dollar floor and base year reserve percentage would be established for the period to which the base year related.

For example, assume a calendar year bank's bad-debt reserve for 1969, was \$3 million which equaled 2 percent of its \$150 million of eligible loans for that year. Its basic dollar floor on the reserve for the period 1970 through 1975 therefore would be \$3 million. If, however, in 1975 (the next base year), the level of its eligible loans dropped below the 1969 level to \$100 million, the dollar floor for 1975 would be 2 percent of the 1975 loan level of \$100 million, or \$2 million. If, as a result of the reduced dollar floor, the actual level of the reserve for 1975 dropped to \$2.5 million, then since 1975 is the base year for the period 1976 through 1981, a new dollar floor for that period of \$2.5 million would be established. If during that period eligible loans fell below \$100 million, the \$2.5 million floor would be reduced proportionately.

Second, the dollar floor on the reserve can be subsequently increased if in a subsequent base year, because of a substantial increase in the volume of loans, the allowable level of the reserve as determined under the applicable percentage is higher. For example, a reserve of 1.8 percent on a substantially increased level of loans in 1975 could give rise to a dollar reserve in excess of that allowable in the year beginning before July 11, 1969. This larger dollar amount (assuming the volume of loans does not subsequently shrink) would then be available as a new higher floor for the subsequent years in the period 1976 through 1981.

² Specifically, if a bank's reserve at the close of a base year (generally, 1969, 1975, and 1981) is less than the amount determined by applying the allowable percentage to the outstanding amount of eligible loans at that time, the bank is permitted to bring the reserve up to this allowable level over the next 5 years provided the allowable level for each of those years is greater than the actual level of the reserve in those years. In any of those 5 years in which the allowable level of the reserve was greater than the allowable level in the base year, the bank also would be permitted to make an addition to its reserve for that year equal to the amount of the increase in the allowable level.

For purposes of this provision, the base years are those indicated in footnote 1 with the following exception. If the year before that in which the bank most recently adopted the percentage method is later than the regularly applicable base year, then that year is the base year.

cluding the definition of the terms "loan" and "eligible loan." However, as under the prior law treatment, eligible loans do not include loans to banks, loans secured by deposits in the lending bank, bonds, debentures, notes, certificates or other evidences of indebtedness issued by a corporation or by a branch of the Government with interest coupons or in registered form and loans of Federal funds and commercial paper, including short-term promissory notes which may be purchased on the open market.

Effective date.—This provision is effective for taxable years beginning after July 11, 1969.

Revenue effect.—The provision is estimated to increase revenue by \$250 million a year when fully effective.

2. Small Business Investment Companies, Etc.—Reserve for Losses on Loans (sec. 431 of the Act and sec. 586 of the code)

Prior law.—In the past, small business investment companies have been allowed to build up a bad-debt reserve amounting to 10 percent of their outstanding loans. This was allowed under a temporary revenue ruling designed to provide a basis for computing the reserve in the absence of experience of the industry or of any comparable industry. Under the law immediately prior to the Act, however, small business investment companies and also business development corporations generally based additions to their bad-debt reserves on their own experience in the current year and the 5 preceding years.

General reasons for change.—Requiring a small business investment company or a business development corporation to base its bad-debt deductions upon its own experience has created problems for new companies. Such companies, although they may subsequently realize losses, initially are unlikely to have much, if any, losses.

Explanation of provisions.—The Act provides that a new small business investment company or a new business development corporation may during the first 10 years of its existence base its bad-debt reserves upon the industry average. After the first 10 years of its existence, a small business investment company or a business development corporation must then base additions to its bad-debt reserves on its own experience.

Effective date.—This provision is to apply to taxable years beginning after July 11, 1969.

Revenue effect.—The revenue effect of this provision is expected to be small.

3. Mutual Savings Banks, Savings and Loan Associations, Etc. (secs. 432 and 434 of the Act and secs. 593, 596, and 7701(a) of the code)

Prior law.—Under existing law businesses generally are entitled to use the reserve method of accounting for bad-debt losses, but in computing this reserve are allowed a tax deduction for an addition to a reserve for bad debts only to the extent it is justified by their actual loss experience.

Under prior law, however, mutual savings banks, savings and loan associations, and cooperative banks (referred to below as "mutual institutions" although including some stock companies) computed additions to their bad-debt reserves on the basis of their actual experience

or under one of two alternative formulas (specified by the 1962 Revenue Act), whichever produced the greater addition to the reserve. The two alternative formulas essentially provided for the deduction of (1) 60 percent of taxable income, or (2) 3 percent of qualifying real property loans. As pointed out above, the taxpayer could deduct the amount dictated by the actual experience of the company, if this resulted in a larger deduction.

Under the 60-percent method, a mutual institution was permitted to deduct each year an amount equal to 60 percent of its taxable income (computed before any bad-debt deduction). However, this deduction could not bring the balance of the bad-debt reserve (at the close of the year) to a level of more than 6 percent of qualifying real property loans.

Under the 3-percent method, an institution was permitted to deduct an amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a "reasonable" amount. In the case of new institutions, the percentage was increased to 5 percent within specified limits. In general, the term "qualifying real property loan" means any loan secured by an interest in improved real property or by an interest in real property which is to be improved out of the proceeds of the loan, subject to certain limitations.

A savings and loan association and a cooperative bank were entitled to use the 3-percent or 60-percent method only if they met a comprehensive set of investment standards. These standards were established by Congress in the 1962 Act to insure that the tax benefits are available only to those institutions primarily engaged in the business of home mortgage financing. In general, these standards required that 82 percent of the institution's assets be invested in residential real estate, liquid reserves, and certain other assets. Mutual savings banks were not subject to any investment standards under these tax provisions and could use the special reserve methods regardless of the amount of their investments in home mortgage financing.

General reasons for change.—In 1952 Congress repealed the exemption of these institutions from Federal income tax and subjected them to the regular corporate income tax. At that time, however, these institutions were allowed a special deduction for additions to bad-debt reserves which proved to be so large that they remained virtually tax exempt. In the Revenue Act of 1962, Congress sought to end this virtual tax exemption by providing the special alternative methods for these institutions in the computation of their bad-debt reserve. Although these methods were more restrictive than prior law, they still provided highly favorable treatment for the bad-debt reserves of these institutions.

It was expected that most of these institutions would compute their deduction under the 60-percent method, which required the payment of some tax, while the 3-percent method would be an alternative primarily benefiting a limited number of new or rapidly growing institutions. In practice, about 90 percent of the savings and loan associations used the 60-percent method, but most mutual savings banks used the 3-percent method and as a result have been able to avoid substantially all Federal income taxes.

Explanation of provision.—The Act revises the tax treatment of mutual savings banks, cooperative banks and savings and loan associations in a number of ways. It eliminates the 3-percent method and reduces the 60-percent method to 40 percent gradually over a 10-year period. This means that, under the Act, the percentage deduction will be as follows:

For a taxable year beginning in—

1969	60 percent
1970	57 percent
1971	54 percent
1972	51 percent
1973	49 percent
1974	47 percent
1975	45 percent
1976	43 percent
1977	42 percent
1978	41 percent
1979 or thereafter	40 percent

As under prior law, the deduction computed under this method (minus the amount added to the reserve for losses on nonqualifying loans) may not exceed an amount necessary to increase the balance of the reserve for losses on qualifying real property loans to 6 percent of these loans.

The Act also deals with the interrelationship of the percentage deduction with the intercorporate dividends received deduction in the case of mutual savings banks and savings and loan associations (the latter, however, under their Federal or State supervision are not permitted to have any appreciable investments in corporate stock). Under prior law the income on which the 60-percent (40 percent under the Act) deduction was computed included net capital gain from the sale of stock and Government obligations and also dividend income qualifying for the intercorporate dividends received deduction. The Act, however, excludes from the base on which the bad-debt deduction is computed: (1) net gain from the sale of corporate stock and tax-exempt Government obligations; (2) any deduction allowable for any addition to the bad debt reserve; (3) the lesser of three-eighths of the net long-term capital gain or three-eighths of the net long-term capital gain from the sale of allowable property other than that described in No. (1) above; and (4) a proportion of dividend income qualifying for the intercorporate dividends received deduction.

In the case of the intercorporate dividends received deduction, the tax treatment referred to above works as follows: the Act, in effect, allocates the deduction between the portion of the income subject to tax and the portion which is allowed as a bad-debt reserve deduction. This disallows a percentage of the dividend received deduction equal to the percentage of the bad debt deduction allowable under the special percentage method (40 percent for those institutions fully entitled to the deduction after the transitional period). The income from corporate securities remaining after the dividends received deduction (the 15 percent remaining after deducting the 85 percent) is not taken into account in the base in determining the bad-debt deduction.

This can be illustrated by assuming a mutual savings bank has \$200,000 of interest income and \$100,000 of dividend income. In this case, under prior law, \$85,000 of the dividend income would not be in-

cluded in the savings bank tax base as a result of the dividend received deduction. However, as a result of the allocation required by the Act, the allowable dividend received deduction is reduced by forty percent, or to \$51,000 (the \$34,000 is included in the base in determining the bad-debt deduction). Also the allowable bad-debt deduction is computed by excluding from its base the portion of the dividend allocated to the other income (i.e., the \$51,000). (The \$15,000, to which the intercorporate dividends received deduction did not apply, also is not taken into account in determining the 40-percent deduction.) Thus, the 40-percent deduction is computed on the basis of the \$200,000 of interest income plus \$34,000 of dividend income. The 40-percent bad-debt deduction in this case would be \$93,600 leaving \$140,400 which, together with the \$15,000 of security income remaining after the dividends received deduction indicates a tax base in this case of \$155,400.

The Act also modifies the standards which must be met to qualify for the special deduction. Under prior law, a savings and loan association (and a cooperative bank) was entitled to use the special percentage deduction method for computing additions to bad debt reserves only if 82 percent of the institution's assets were invested in residential real estate, liquid reserves and certain other assets. The Act revises the prior investment standards applicable to savings and loan associations by liberalizing the composition of the qualifying assets. The new standards are also made applicable to mutual savings banks. The new investment standard is a flexible one which reduces the percentage (applied against taxable income, with certain adjustments, to compute the bad-debt reserve deduction) depending upon the percentage of investments in the qualifying assets—residential real property loans, liquid reserves, and certain other assets. The full percentage (40 percent at the end of a 10-year period) is allowed generally only if the institution has a prescribed percentage—82 percent for savings and loan associations and cooperative banks and 72 percent for mutual savings banks—of its investments in qualifying assets. The percentage is reduced by $\frac{3}{4}$ of 1 percent for every 1 percent that a savings and loan institution's qualifying assets are less than the prescribed percentage of total assets (or by 1.5 percentage points for every 1 percent in the case of mutual savings banks since they are only required to meet the 72-percent test on qualified assets). However, if less than 60 percent of the institution's funds are in qualifying assets (50 percent for mutual savings banks before 1973), the percentage deduction method may not be used. As an alternative, the Act allows these institutions to compute their bad-debt reserves on the basis of an average year's losses determined under a 6-year moving average of their own experience rather than on the basis of the percentage deduction method.

An example where the above stated percentage reductions will apply is as follows: if in 1980 (at which time the 10-year transitional period will have reduced the percentage for the special deduction method to 40 percent) either type of institution has only the minimum 60 percent of its funds in qualifying assets, the percentage deduction for a savings and loan association would be 23.5 percent (a 16.5-point reduction from 40 percent because it is 22 points below the 82-percent level for qualifying assets), and the percentage deduction for a mutual savings bank would be 22 percent (an 18-point reduction from 40 percent because it is 12 points below the 72-percent level for qualifying assets).

The Act also modifies somewhat the types of assets which are taken into account in determining whether a mutual institution qualifies under the asset requirement. Under the Act, the following investments are included in qualifying assets for this purpose:

(1) Loans for residential real property, including real property primarily used for church purposes, facilities in residential developments dedicated to public use (e.g., schools and libraries), and property used on a nonprofit basis by residents (e.g., swimming pools, etc.) and mobile homes not used on a transient basis.

(2) Loans for the improvement of commercial or residential property in an urban renewal area or in an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act.

(3) Loans for educational, health and welfare institutions or facilities including facilities primarily for students, residents, etc.

(4) Property acquired through the liquidation of any of the prior three categories.

(5) Student loans.

(6) Property used by the mutual institution in its business.

The Act also includes loans secured by an interest in real property located in an urban renewal area to be developed for predominantly residential use under an urban renewal plan or located in an area covered by a program under the Demonstration Cities and Metropolitan Development Act. Loans for residential purposes are also defined as including loans secured by redeemable ground rents and it is made clear that real property loans include loans to finance the acquisition or development of land which is to become residential property if there is assurance that the building will actually occur within a period of 3 years (with retroactive disqualification of the loan if this does not occur). The Act also makes it clear that an apartment building with a few commercial establishments in it qualifies as residential property for this purpose if 80 percent of the usable space in the building is residential space.

The qualifying assets also may include certain liquidity items, including cash, time and demand deposits in banks, loans secured by a deposit (or share) of a member, obligations of the United States and stock or obligations of an instrumentality of the United States or obligations of a State or local governmental unit whose interest payments are not excludable from gross income. This last item reflects a change from prior law under which tax exempt bonds were considered as qualifying investments for purposes of the investment standard (for savings and loan associations), but because they were tax-exempt they gave rise to no income on which the 60-percent deduction was based; consequently, under the Act such assets are to be excluded from qualifying assets.

The Act also gives mutual institutions the option of computing their bad debt reserves on the basis of the commercial bank formula (based on a percentage of eligible outstanding loans plus their actual losses on ineligible loans), in lieu of the bad debt reserves outlined above. An institution may use either the percentage deduction method or the commercial bank formula method in any year, but not both. If it uses the commercial bank formula, the institution determines the deduction on the amount of its eligible loans, subject to the limitations which apply

to commercial banks as well as the limitation on the amount of an addition to the reserve for losses on qualifying real property loans.

In determining the amount deemed to be the balance of the reserve for eligible loans when an institution elects to use this formula to compute its bad debt reserve deduction, an institution combines all its existing reserves (its qualifying, nonqualifying, and supplemental reserves), and the total is treated as the reserve for eligible loans. The institutions are also allowed to take a deduction for their actual losses on their ineligible loans. Institutions availing themselves of this option are not permitted to derive undue advantage from switching from one method of computing bad debt reserves to another. This is because an institution that switches to another reserve method must add to that reserve only the amount that would have been permitted had it been consistently on that reserve method throughout the years.

Having reduced the tax-free amount that these mutual institutions are allowed to add to their bad debt reserves, the Act permits these institutions (and commercial banks), a more generous net operating loss carryback to minimize any possibility of hardship from an unexpected surge of bad debt losses. Under prior law, all financial institutions, like other taxpayers under existing law, could carry net operating losses back 3 years and forward 5 years. The Act permits financial institutions after December 31, 1975, to carry net operating losses back 10 years and forward 5 years, in effect, allowing them 15 years to spread their losses.

Effective date.—These provisions are effective for taxable years beginning after July 11, 1969.

Revenue effect.—The revenue increases under these provisions are estimated at \$45 million in 1970, \$90 million in 1974 and \$120 million in the long run.

4. Treatment of Bonds Held by Financial Institutions (sec. 433 of the Act and sec. 582 of the code)

Prior law.—Commercial banks, mutual savings banks and savings and loan associations received special tax treatment in regard to their transactions in bonds and other corporate and governmental evidences of indebtedness. Unlike other taxpayers, they were allowed (under sec. 582 of the code) to treat any excess of losses over gains from these transactions as an ordinary loss and could deduct this loss without limit from ordinary income. Small business investment companies also were allowed under prior law ordinary loss treatment on certain convertible debentures (under sec. 1243 of the code). However, banks received the same treatment as other corporate taxpayers when they had an excess of long-term capital gains over capital losses from such transactions in that such gains were treated as long-term capital gains for tax purposes.

In other words, these financial institutions received nonparallel treatment with regard to their capital gains and capital losses on bonds and other corporate and governmental evidences of indebtedness. A net gain on bonds was taxed as a capital gain; but a net loss on bonds was deducted against ordinary income.

General reasons for change.—The nonparallel treatment of gains and losses on bond transactions by financial institutions had inequitable results.

Transactions of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital transactions; they are more akin to transactions in inventory or stock in view of the size and the purposes of the bank holdings of these items and the extent of their transactions in them. Moreover, financial institutions were maximizing their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years. This enabled them to report the bulk of their gains as capital gains for tax purposes and the bulk of their losses as ordinary losses chargeable against regular income. The result was to permit financial institutions to reduce their tax liability and to receive preferential treatment over other taxpayers.

Explanation of provision.—The Act eliminates the preferential treatment accorded to financial institutions' transactions in corporate and Government bonds and other evidences of indebtedness by providing parallel treatment of gains and losses on these transactions. Under the Act, financial institutions treat net gains from these transactions as ordinary income instead of as capital gains; however, they continue to treat net losses from such transactions as ordinary losses as under prior law.

For consistency, the parallel treatment for financial institutions applies to transactions not only in Government and corporate evidences of indebtedness but to all evidences of indebtedness. Theoretically, it would be possible to provide parallel treatment for such transactions by treating the gains as capital gains and the losses as capital losses. However, the ordinary income tax treatment which the Act provides was regarded by the Congress as a preferable means of achieving parallel treatment for two reasons: (1) it recognizes that transactions by financial institutions in evidences of indebtedness are not true capital items, but rather are more akin to transactions in inventory or stock items and (2) the ordinary income tax route, by allowing losses in such transactions to be treated as ordinary losses, gives financial institutions more effective tax relief for their losses.

The Act provides a special transitional rule designed to recognize the investment problems of the financial institutions, which acquired securities under the assumption that they would be able to continue the treatment accorded under prior law. Under this transitional rule, gains from bonds acquired by a financial institution on or before July 11, 1969, and sold after this date continue to receive capital gains treatment for the portion of the gain attributable to the period prior to July 12, 1969; the portion of the gain attributable to the period after July 11, 1969 receives ordinary income treatment. This division of the gain into capital gain and ordinary income is determined when the bonds are sold, based pro rata on the number of days the bonds were held before and after July 12, 1969.

The Act provides that small business investment companies and business development corporations are to receive the same treatment as other financial institutions with regard to their gains and losses on bond transactions. However, since these two types of organizations under prior law received capital gain and capital loss treatment on their bond transactions (except for certain convertible debentures in the case of small business investment companies), the Act contains a

provision which allows small business investment companies and business development corporations to elect whether gains and losses incurred on bonds sold during a 5-year transition period will receive regular capital gain and capital loss treatment or ordinary income and loss treatment. This election is for the entire 5-year period and is irrevocable. This means that these organizations can continue to have capital gain and capital loss tax treatment during the entire 5-year transition period or can have the new ordinary income and loss treatment applying immediately upon the effective date of this provision.

Effective date.—This provision applies with respect to taxable years beginning after July 11, 1969.

Revenue effect.—The revenue increases under this provision are estimated at \$5 million for the year 1970, \$15 million in 1972 and \$50 million when fully effective.

5. Financial Institutions—Net Operating Loss Carryback (sec. 431 of the Act and sec. 172(b)(1)(F) of the code)

Prior law.—Under prior law, financial institutions, including commercial banks, small business investment corporations, business development corporations, mutual savings banks, savings and loan associations, etc., were allowed the same net operating loss carrybacks and carryforwards as other corporations: a 3-year carryback and a 5-year carryforward of net operating losses.

General reasons for change.—The Act provides for gradual elimination or substantial reduction of the special prior law treatment that permitted financial institutions to build up unduly generous bad-debt reserves. While this action makes a significant contribution to more equitable treatment of bad-debt reserves, it nevertheless was believed desirable to provide financial institutions protection against substantial losses should a future downturn in the economy bring about such a result.

Explanation of provision.—The Act grants financial institutions (including banks, small business investment corporations, business development corporations, mutual savings banks, savings and loan associations, etc.) a 10-year net operating loss carryback, instead of the 3-year carryback granted under prior law. The new longer carryback is in addition to the 5-year carryforward, which continues to be available. This more liberal loss carryback treatment is also extended to banks for cooperatives (as defined in section 2 of the Farm Credit Act of 1933).

Effective date.—The provision is effective for net operating losses incurred in a taxable year beginning after December 31, 1975, in the case of financial institutions and for net operating losses on taxable years beginning after December 31, 1969, for banks for cooperatives.

Revenue effect.—The revenue effect of this provision is expected to be small.

6. Mergers of Savings and Loan Associations (sec. 432 of the Act and sec. 593(f) of the code)

Prior law.—Under existing law a taxpayer which previously deducted additions to its bad debt reserve for tax purposes must restore the reserve to income when the need for the reserve ceases. An example of a situation where a taxpayer's need for a bad debt reserve ceases is where the taxpayer sells all of its assets including its accounts receivable.

In general, where there is a tax-free merger or reorganization the need for the bad debt reserve is considered to continue and, accordingly, the acquired corporation is not required to restore the reserve to income and it is carried over to the acquiring company. On the other hand where a transaction is a purchase of assets or is treated as a purchase of assets (i.e., where a corporation purchases the stock of another corporation which it then liquidates under sec. 334(b)(2)), the need for the reserve is considered to cease and, accordingly, it must be restored to income.

In the case of mergers or reorganizations of savings and loan associations, the status of the reserves for losses on loans also depends on whether for tax purposes the merger is characterized as a tax-free reorganization or as a taxable sale. In general, if the merger or reorganization is tax-free, then the bad-debt reserve of the acquired association is carried over; however, if the merger is not tax-free, then the bad-debt reserve is restored to income and taxed (sec. 593(f)).

General reason for change.—Where there is a merger of savings and loan associations which is treated under present law as a tax-free reorganization (or liquidation), existing law has been interpreted as not requiring the acquired association to restore its bad debt reserve to income. However, since existing law is not explicit on this point, it is usually necessary for the associations to obtain a ruling on this point from the Internal Revenue Service. The delay involved in this may be especially detrimental in the case of supervisory mergers. (A supervisory merger is one encouraged or instituted in the public interest by the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board involving one or more savings and loan associations with financial or managerial problems.) There does not appear to be any necessity to require the association to acquire a ruling in case of any tax-free reorganization or liquidation.

Explanation of provision.—The Act provides that in those cases where section 381 applies (relating to carryovers in certain corporate acquisitions which qualify as tax-free reorganizations or liquidations), the bad-debt reserves do not have to be restored to income (i.e., the provisions of sec. 593(f) are not applicable). This provision is intended merely to be declaratory of existing law where the bad-debt reserve is carried over to the acquiring corporation (under sec. 381).

Effective date.—This provision is to apply with respect to taxable years beginning after July 11, 1969.

7. Foreign Deposits in U.S. Banks (sec. 435 of the Act and secs. 861 and 2104 of the code)

Prior law.—Existing law provides special rules for the treatment under the income tax and the estate tax of U.S. bank deposits, and the interest thereon, of foreign persons (i.e., nonresident alien individuals and foreign corporations).

A foreign person generally is subject to U.S. income tax only on the income he derives from the United States. Although interest paid by a U.S. person (other than a foreign banking branch of a U.S. corporation) to a foreign person generally is considered to be U.S. source income and generally is subject to U.S. tax, a special rule provides that interest on U.S. bank deposits which is paid to foreign persons, and which is not effectively connected with the conduct of a trade or business carried on by the person within the United States, is

not to be treated as U.S. source income. In other words, this type of interest income presently is not subject to U.S. tax.

The estate tax is imposed, in the case of a nonresident alien individual, generally only on the individual's property which is located in the United States. A special rule provides that a nonresident alien individual's bank deposits in the United States are not to be considered property located in the United States and, thus, are not subject to the estate tax, if the interest on the deposits was not taxable under the special income tax rule.

Under prior law, the special bank deposit rules were to cease to apply at the end of 1972. In other words, after 1972 the interest on these bank deposits would have been subject to income tax and the bank deposits themselves would have been subject to the estate tax.

The rules provided under prior law in the case of deposits by foreign persons with a U.S. banking branch of a foreign corporation differed somewhat from the rules described above with respect to deposits in U.S. banks. In the case of a U.S. banking branch of a foreign corporation, the interest on the bank deposit was not considered U.S. source income even if it was effectively connected with the conduct of a U.S. trade or business carried on by the foreign person (except where all or a portion of the interest paid by the foreign corporation generally was treated as U.S. source income because 50 percent or more of the corporation's worldwide income was effectively connected with a U.S. business). In addition, deposits of a nonresident alien in a U.S. banking branch of a foreign corporation were not considered to be property located in the United States for estate tax purposes. Under prior law, these special rules were to cease to apply at the end of 1972. Thus, after 1972, interest on deposits with a U.S. banking branch of a foreign corporation would have been considered U.S. source income and the bank deposits themselves would have been considered located in the United States.

General reasons for change.—Congress provided, in 1966, that the special treatment accorded U.S. bank deposits of foreign persons should be terminated. It was believed, however, that an immediate elimination of the special rules might have a substantial adverse effect on the balance of payments. Accordingly, it was decided to postpone the elimination of the special rules until the end of 1972. In view of the continuing deficit in the balance of payments, it appears that our balance-of-payments situation might be adversely affected to a substantial degree if the special treatment were removed at the end of 1972. On the other hand, there appears to be no reason for according deposits in U.S. banking branches of foreign corporations different treatment than that accorded deposits in U.S. banks (i.e., exempting from income tax the interest on deposits of foreign persons in these U.S. banking branches, even where the income is effectively connected with a U.S. business, and also exempting the deposits themselves from the estate tax imposed on nonresident alien individuals).

Explanation of provision.—The Act provides that in the case of deposits in U.S. banks, the special income and estate tax rules regarding U.S. bank deposits (including deposits with savings and loan associations and certain amounts held by insurance companies) of foreign persons are to continue to apply until the end of 1975. As a result, interest on U.S. bank deposits of foreign persons, which is not effec-

tively connected with a U.S. business of the foreign person, will continue to be treated as from foreign sources (and, thus, exempt from U.S. income tax), and the deposits themselves will continue to be treated as located outside of the United States (and, thus, not subject to the U.S. estate tax) until the end of 1975.

The Act also revises the treatment of deposits in U.S. banking branches of foreign corporations to provide the same treatment as exists when the deposits are in the United States in U.S. banks. Under the Act, interest on a deposit of a foreign person in a U.S. banking branch of a foreign corporation is treated as from foreign sources (and, thus, not subject to U.S. income tax) only if the interest is not effectively connected with a U.S. business carried on by the foreign person. In addition, the deposits themselves are treated as located outside the United States (and, thus, not subject to the U.S. estate tax imposed on nonresident alien individuals) only if the interest is not effectively connected with such a U.S. business. As is true in the case of deposits of foreign persons in U.S. banks, these special rules cease to apply after 1975.

Effective date.—The changes made by the Act in the case of deposits in U.S. banking branches of foreign corporations apply for income tax purposes with respect to interest paid after 1969 and for estate tax purposes with respect to nonresident aliens dying after 1969.

O. DEPRECIATION ALLOWED REGULATED INDUSTRIES

(Sec. 441 of the Act and sec. 167(1) of the code)

Prior law.—Under prior law, regulated industries could make the same elections as other taxpayers regarding depreciation of their business property. As of 1969, about half the regulatory agencies required utilities that used accelerated depreciation to “flow through” the resulting reduction in Federal income taxes currently to income. (Where the utility was earning the maximum allowed by law or regulations, this resulted in flowing through the tax reduction to the utility’s current customers.) Some agencies insisted that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, treated the utilities as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight line depreciation. Other agencies permitted the utilities under their jurisdiction to “normalize” the deferred tax liabilities resulting from accelerated depreciation. This allows the utility to retain the current tax reduction and to use this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.

General reasons for change.—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to annual revenue losses of approximately \$1.5 billion. The Congress believed that such a revenue loss from this item would be unacceptable at this time. On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an

unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area also is complicated by the fact that many utilities do not have effective monopolies while others do, many utilities are in growing industries while others are losing ground, and many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

In light of the factors outlined above, the Congress concluded that it is appropriate in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change was made by this provision of the Act regarding utility industries whose members are generally earning well below their permitted rates of return.

Explanation of provisions.—In general the Act provides that if a company (a) is in one of the regulated industries to which the Act applies and (b) as of August 1, 1969, either took accelerated depreciation and normalized its deferred taxes or took straight line depreciation, then the company is permitted to take accelerated depreciation on its tax return only if it normalizes on its regulated books of account and for ratemaking purposes. Companies that used flow-through as of August 1, 1969, unless certain elections are made, are to continue to do so.

More specifically, in the case of existing property the following rules apply:

(1) If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

(2) If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.

(3) If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so (except for a special election procedure discussed below), unless the appropriate regulatory agency permits a change as to that property. That is, the Act does not require the taxpayer to flow through, but it also does not affect any power the regulatory agency might have to require the taxpayer to flow through.

In the case of new property, the Act provides that if the taxpayer as of August 1, 1969, flowed through to its customers the benefits of accelerated depreciation then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change (or unless the election below applies). In all other cases (in those regulated industries, listed below, to which the Act applies), accelerated depreciation is permitted only if the utility normalizes the deferred income taxes. In these situations the taxpayer is permitted to elect straight line depreciation as to the new property. If the taxpayer seeks to use accelerated depreciation, the regulatory agency may permit it to normalize; if the regulatory agency does not, the taxpayer must use straight line depreciation.

The Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the base upon which the agency computes the company's rate of return.

The Act provides that the rules set forth above apply to property used predominantly in the trade or business of the furnishing or sale of—

- (1) Electrical energy;
- (2) Water;
- (3) Sewage disposal services;
- (4) Gas or steam through a local distribution system;
- (5) Telephone services, or other communication service furnished by Comsat; or
- (6) Transportation of gas or steam by pipeline.

In all of the above cases the rules of the Act apply if the rates for such furnishing or sale are regulated by a utilities commission or similar agency.

As indicated above, for a limited period of time and to a limited extent utilities on flow-through could elect straight line depreciation or accelerated depreciation with flow through. The Act permits an election to be made within 180 days after the date of enactment of the Act—i.e., by June 28, 1970—for a utility in one of the regulated industries covered by this provision to shift from the flow-through to the straight line method, with or without the permission of the appropriate regulatory agency, or to permit it with the permission of the regulatory agency to shift to the normalization method, that is, to come under general rules of the Act.

This election applies to new property, but only to the extent it increases the taxpayer's capacity. In order to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, the Act provides that the election will take effect at the start of the company's first taxable year beginning after December 31, 1970. If the books and rates have been conformed to normalization by then, the company may continue to use accelerated depreciation so long as it continues to normalize; if not, the company must use only straight line depreciation. Since the company would no longer be permitted to use accelerated depreciation (unless the agency permits it to normalize), the agency would not be able to impute the use of accelerated depreciation with flow-through. In other words, a company that makes this election would be under the general rule of the Act (as to property qualifying for the election) after its election takes effect.

In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The Act permits such a definition of normalization and does not require that additions be to a separate account described as a "reserve for deferred taxes."

Under the Act, the requirement for normalizing is not met by simply normalizing on the regulated books of account of the utility, if these books of account may be ignored by the regulatory agency in setting rates. Although the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is because the use of flow-through in setting rates would produce the revenue loss the Congress sought to avert.

The Act provides that a taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized. This rule is to be applied after July 30, 1969, only.

Under this rule, differences in the amount of depreciation expense need not be normalized if they result from such differences as (a) use of so-called "guideline lives" for tax purposes and "engineering lives" on the regulated books and (b) different bases for the property because the agency requires that certain carrying charges be capitalized even though for tax purposes they may be deducted or because the agency requires a carryover basis in the case of a purchase of property from another regulated utility even though for tax purposes the basis is what the purchasing company paid for the property.

However, any difference resulting from a faster method of depreciation (including the use of a faster declining balance rate) must be normalized. For example, if a company takes straight line depreciation on its regulated books of account and 200-percent declining balance on its tax return, it does not meet the test of the Act if it normalizes only with respect to the difference between 200-percent declining balance and 150-percent declining balance.

Under the Act, the status of a company as to whether it is on straight line, normalizing, or flow-through is determined as of August 1, 1969.

Accordingly, the determination of the pertinent method of depreciation generally is made by reference to the return for the last taxable year for which a return was filed before August 1, 1969. (It is expected that in most cases this will be the return for calendar 1968). Property not reflected on that last return as public utility property, which is used as public utility property before January 1, 1970, is treated the same as property of the same kind or, if there is no property of the same kind, property of the most nearly similar kind reflected on that return. If the company's last tax return reflected two methods of depreciation for a kind of property—for example, where it used straight line depreciation for property put in service through 1964 but used 200 percent declining balance for property put in service since then—the method to be used for property not reflected on the return would be 200 percent declining balance, the method used for the newer property.

Under another provision of the Act (sec. 521, described below), real estate depreciation allowances have been revised, and the most accelerated methods of depreciation (the 200-percent declining balance and sum of the years-digits methods) are no longer permitted with respect to new real estate (other than housing), and later-acquired used nonhousing real estate is limited to straight line depreciation. The Act provides that in the case of real estate to which the new limitations on allowable depreciation for regulated utilities apply, that method permitted by the new limitations which is most nearly comparable to the method of depreciation used on the taxpayer's pre-August 1, 1969, return is to be considered to be the taxpayer's pertinent method of depreciation. For example, if the taxpayer used 200-percent declining balance for its new property on its latest tax return filed before August 1, 1969, and in the future acquires new public utility property of the same kind, the 150-percent declining balance method would be its most nearly comparable method.

Under the Act, the status of a company is not necessarily determined only by the method of depreciation used on its tax return. Utilities that have used accelerated depreciation (with flow-through) in computing their tax expense on their regulated books of account for the latest accounting period ending before August 1, 1969, are permitted to elect accelerated depreciation (with flow-through) for such property and for future acquisitions. In addition, a utility which had filed a request with the Internal Revenue Service before August 1, 1969, for permission to change from straight line to accelerated depreciation is permitted to make that change for such property and for future acquisitions.

When the term "straight line depreciation" is used in the above description (and also with regard to the earnings and profits and the real estate depreciation provisions, described below) it is intended to encompass also other ratable methods such as units of production and machine hours (but not the so-called "forecast of income" method).

The Act also authorizes the use of regulations to provide for proper application of this provision where more than one agency supervises the activities of a company if the several agencies apply different rules to the company's property, where companies are involved in reorganizations, mergers, or other acquisitions, and in other circumstances in order to carry out the purposes of this provision.

Effective date.—The new rules apply to all taxable years for which a return has not been filed before August 1, 1969, even though those years may have ended before that date.

Revenue effect.—The revenue increases under the provision are estimated at \$60 million in calendar year 1970, \$260 million in 1974, and \$310 million in the long run.

P. TREATMENT OF DEPRECIATION FOR EARNINGS AND PROFITS

(Sec. 442 of the Act and sec. 312(m) of the code)

Prior law.—A dividend is defined under present law (unchanged by the Act) as a distribution of property (which includes 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, then 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). Earnings and profits generally were computed by reference to the method of depreciation used in computing the corporation's taxable income and so were reduced by the amount of depreciation deducted by the corporation on its return.

General reasons for change.—Tax-free dividends from accelerated depreciation—in effect, resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates—appeared to be increasing in a number of industries. Especially among utilities, a number of companies were regularly making such distributions. It was indicated that in 1968, private power companies alone made approximately \$260 million of such tax-free distributions. Statistical information is not readily available in the real estate industry on this point, but it is understood that substantial amounts of corporate distributions in this industry

were also tax free. Availability of these tax benefits is generally unrelated to the purposes of accelerated depreciation and is of greatest value to individual stockholders in high tax brackets.

The Congress concluded that corporations should not be allowed to continue to make such nontaxable distributions.

Explanation of provisions.—The Act provides that, for the purpose of computing its earnings and profits, a corporation is to deduct depreciation on the straight line method, or on a similar method providing for ratable deductions of depreciation over the useful life of the asset. In effect, this conforms the law regarding depreciation to present practice regarding depletion. (Regulations § 1.312-6(c)(1) provides that cost depletion must be used in determining earnings and profits of a corporation that uses percentage depletion in computing its taxable income.) This provision also applies to corporations which use the rapid methods of amortization under sections 168, 169, or 184 (the latter added by this Act). However, it is not intended to affect the amount of depreciation that may be deducted by a corporation under sections 167 or 179 or the amortization deduction allowable under sections 168, 169, or 184 in determining taxable income. Similarly, the provision does not affect the computation of real estate investment trust taxable income in determining whether the trust paid dividends equal to or in excess of 90 percent of its taxable income. However, the provision applies to a real estate investment trust for the purpose of computing its earnings and profits and, therefore, the taxability of distribution to shareholders or holders of beneficial interests in such a trust.

When property depreciated under this rule is sold, the amount of gain or loss taken into earnings and profits is adjusted to compensate for any difference between the tax return depreciation deductions and the earnings and profits depreciation deductions up to the time of sale. This results from the application of a rule of existing law, which presently has the effect of requiring the corporation to adjust its earnings and profits basis in the case of depletion by the amount allowed in computing earnings and profits and not by the amount of depletion taken as a deduction on its income tax return.

This rule as to the method of computing earnings and profits does not apply for purposes of the various determinations relating to the earnings and profits of a foreign corporation if less than 20 percent of its gross income for the taxable year in question is derived from sources within the United States. Thus, for example, the amount of the deemed paid foreign tax credit allowed a company receiving dividends from such a foreign corporation is computed as under existing law and is not affected by this provision of the Act.

In view of the very substantial changes in the taxation of operations conducted abroad through foreign corporations which would be affected by this provision, the Congress did not believe it appropriate at this time to apply this type of provision to foreign corporations operating abroad.

Effective date.—This provision applies to the computation of earnings and profits with respect to taxable years beginning after June 30, 1972. The 3-year delay is expected to be sufficient to avoid drastic reductions in the market values of the shares of corporations which were making such tax-free distributions

Revenue effect.—The revenue increase under this provision is estimated at \$80 million annually beginning in 1973.

Q. NATURAL RESOURCES

1. Percentage Depletion (sec. 501 of the Act and sec. 613(b) of the code)

Prior law.—Starting in 1926, percentage depletion for oil and gas wells was allowed at the rate of 27½ percent of the gross income from the property. In subsequent years, starting in 1932, percentage depletion at lower rates was extended to most other minerals.

Under prior law the percentage depletion rates were 27½ percent for oil and gas wells; 23 percent for sulfur, uranium, and an extended list of minerals from domestic deposits; 15 percent for metal mines, rock asphalt, vermiculite, and certain types of clay; 10 percent for coal and a limited group of other minerals; 7½ percent for clay, shale, and slate used for specified purposes; and 5 percent for such items as gravel, peat, and sand, and certain minerals from brine wells. In addition, a 15-percent rate applied to a final category which contains an extended series of minerals and also includes all other minerals (unless sold for riprap, ballast, road material, rubble, concrete aggregates, or for similar purposes, in which case the applicable rate was 5 percent). Percentage depletion is not granted in the case of soil, sod, dirt, turf, water, or mosses or minerals from sea water, the air, or similar inexhaustible sources.

General reasons for change.—Percentage depletion was adopted in 1926, when the prior allowances based on discovery value in the case of oil and gas proved difficult to administer and produced varying results. At that time, it was recognized that percentage depletion could permit taxpayers to recover amounts in excess of their investments. This was deemed justified on the ground it would have the beneficial effect of stimulating exploration for, and discovery of, new reserves of vitally needed oil and gas.

In adopting the Act, the Congress concluded that if percentage depletion rates are viewed as a needed stimulant at the present time, they were higher than needed to achieve the desired increase in reserves.

Explanation of provisions.—The Act reduces the percentage depletion rate for both foreign and domestic oil and gas wells from 27½ percent to 22 percent.

In the case of minerals that received percentage depletion at a rate of 23 percent under prior law, the rate also is reduced to 22 percent. Molybdenum, which received percentage depletion at the rate of 15 percent under prior law, is included in the 22 percent category.

In the case of those minerals which received percentage depletion at the rate of 15 percent under prior law, the rate is reduced to 14 percent, except for domestic gold, silver, copper, iron ore, and oil shale.

Effective date.—The changes in percentage depletion rates are effective for taxable years beginning after October 9, 1969.

Revenue effect.—It is estimated that this provision will result in an annual revenue gain of \$235 million.

2. Minerals Obtained from Saline Lakes (sec. 501 of the Act and sec. 613(b) of the code)

Prior law.—Percentage depletion is not allowable with respect to minerals from sea water, the air, or similar inexhaustible sources. Prior to the Act, the Internal Revenue Service took the position that percentage depletion is not permitted with respect to minerals taken from the Great Salt Lake because it considers the Great Salt Lake (a perennial lake) to be an inexhaustible source.

General reasons for change.—Although the water from the Great Salt Lake is replenished to a certain extent, the replenishment has been diminished in recent years by water conservation practices in the surrounding area. Congress therefore decided to permit percentage depletion with respect to minerals (other than salt) extracted from the Great Salt Lake and other saline perennial lakes within the United States.

Explanation of provision.—The Act provides that for purposes of percentage depletion, minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States are not to be considered minerals from an inexhaustible source. Thus, the special percentage depletion rates are to be available with respect to these minerals. For purposes of determining the percentage depletion cutoff point in these cases, the extraction of the minerals from the brine is to be considered an ordinary treatment process. This does not include, however, further processing or refining.

This amendment is not intended to affect the availability of percentage depletion on sodium chloride from saline lakes in cases where the source of the sodium chloride is exhaustible.

Effective date.—This amendment applies to taxable years beginning after October 9, 1969.

3. Treatment Processes in the Case of Oil Shale (sec. 502 of the Act and sec. 613(c) of the code)

Prior law.—Oil shale is a sedimentary rock from which liquid oil can be extracted by application of heat. Under prior law, the percentage depletion allowance for oil shale applied only to the value of the rock itself after extraction from the ground and crushing. Percentage depletion could not be computed on the value of the liquid oil which is produced by subjecting the rock to the retorting process.

General reasons for change.—Although the United States has very large reserves of oil shale, there is virtually no production of oil from this source. Existing levels of technology do not permit shale oil to be produced on a basis competitive with oil produced from wells. The Act provides, as an incentive for investment in research and technological development in the processing of shale oil, a depletion allowance for oil produced from shale which more nearly corresponds to the depletion allowance for oil produced from wells.

Explanation of provision.—The Act provides that percentage depletion is to be computed in the case of shale oil on its value after extraction from the ground, crushing, loading into the retort, and retorting, but before hydrogenation, refining, or any other process subsequent to retorting.

Effective date.—The amendment is effective for taxable years beginning after December 30, 1969.

Revenue effect.—The immediate revenue effect of this provision will be negligible because there is no significant production of oil from oil shale at the present time. However, as technological problems are solved and shale oil is produced in quantity, there will be a corresponding increase in the loss of revenue.

4. Mineral Production Payments (sec. 503 of the Act and sec. 636 of the code)

Prior law.—A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. The payment is secured by an interest in the minerals, the right to the production is for a period of time shorter than the expected life of the property, and the production payment usually bears interest. Depending on how a production payment is created, it may be classified as a carved-out production payment or a retained production payment which may then be used in a so-called A-B-C transaction.

A carved-out production payment is created when the owner of a mineral property sells—or carves out—a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under prior law, the amount received by the seller of the carved-out production payment generally was considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treated the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally paid no tax on those amounts (except on that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment were excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income were deducted by him in the year they were incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under prior law the owner of the retained production payment received income for which percentage depletion could be taken during the payout period, or period during which he received a part of the production (or a payment based on production). The purchaser of the working interest excluded the amounts used to satisfy the production payment during the payout period, but deducted the cost of producing the minerals subject to the production payment.

The so-called A-B-C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A-B-C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.

General reasons for change.—The treatment of mineral production payments under prior law resulted in what were essentially two problems, one relating to carved-out production payments and one relating to retained production payments and A-B-C transactions. In the case of the carved-out payments, by advancing the time income (but not the related expense) was reported for tax purposes, taxpayers were

able to avoid limitations based on net or taxable income—principally the 50-percent limitation on taxable income from the property for percentage depletion purposes, but also the foreign tax credit limitation, the 5-year net operating loss carryover limitation, and the 7-year investment credit carryover. In the case of A-B-C transactions, taxpayers were able to amortize or pay off what was essentially a loan with before-tax dollars rather than after-tax dollars.

In each of the three situations (the carved-out production payment, the retained production payment, and the A-B-C transaction), the transaction is similar, in fact, to a loan transaction with the loan secured by a mortgage on the property and the "borrower" not personally liable for the loan. In a carve-out, the analogy to a loan is the borrowing of money (selling a production payment). In an A-B-C transaction, the analogy is to the sale of a property but subject to a mortgage subsequently sold to someone else. The tax treatment of these two situations under prior law, however, was significantly different with substantially greater benefits accorded in the case of the A-B-C transaction. This difference lay in the fact that in the A-B-C transaction, B (the purchaser of the working interest in the oil property) could amortize C's (the lender's) capital interest out of tax-free dollars rather than the "after-tax dollars" he would have had to use if he had purchased some other property, such as an apartment building.

In recent years, the use of mineral production payments increased substantially. In 1965, reported carved-out production payment transactions totaled \$214 million. One year later, this amount had more than doubled to a figure of \$540 million. This represented a revenue loss to the Federal Government of \$70 million. The reported amount of so-called A-B-C transactions in 1966 totaled \$1.85 billion. Moreover, the use of the A-B-C transaction had spread to industries where it previously was not used. For example, the use of production payments was almost unknown in the coal industry several years ago. However, within recent years, coal properties have been sold, subject to retained production payments of approximately \$800 million.

The Congress saw no reason why a person who, in effect, is the borrower in a production payment transaction should be allowed to pay off the loan with tax-free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars. In addition, it was believed that Congress did not intend to permit the avoidance of the limitation on depletion deductions and the mismatching of income and expenses which creates artificial tax losses by the use of production payments. Moreover, there was a substantial revenue loss which resulted from the use of production payments. It is estimated that the combined revenue loss from ABC transactions and carved-out production payments was between \$200 and \$350 million annually. An acceleration of the revenue loss could have been expected unless corrective action was taken.

Explanation of provision.—In general, the Act treats a production payment transaction as a loan transaction; that is, a loan by the owner of the production payment to the owner of the mineral property. This is the same treatment as provided under existing law whenever the payout of a production payment, in the case of a carve out, is in any manner guaranteed by the person who created it, or, in the case of an A-B-C transaction, is guaranteed by B, the purchaser of the working interest.

In the case of a carved-out production payment, the payment is treated as a mortgage loan on the mineral property (rather than as an economic interest in the property). Thus, the proceeds received by the seller upon a sale of a production payment will not be taxable to him. However, as income is derived from the property subject to the carve out, that income will be taxable to the owner of the property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments will be deductible when incurred.

This treatment does not apply to a production payment carved out for exploration or development of a mineral property if gross income would not be realized by the person creating the production payment in the absence of the Act. For example, if A, the owner of a lease, carves out a production payment in favor of X in consideration of the drilling by X of a well on the lease owned by A, gross income is not realized by A on this transaction and A is not entitled, of course, to deduct the drilling costs incurred by X. Similarly, if A carves out a production payment for \$100,000 and sells it to X for \$90,000 and agrees to use the proceeds in drilling development wells on the lease to which the carve out relates, the \$90,000 is not income to A and A cannot, of course, deduct the \$90,000 spent in drilling the development wells. Thus, the Act does not treat the production payment as a loan in the case of either of the above examples, and in each case the production payment held by X continues to be treated as an economic interest in his hands.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the Act provides that the production payment is treated as the equivalent of a purchase money mortgage loan (rather than as an economic interest in the mineral property). Accordingly, the income derived from the property which is used to satisfy the payment will be taxable to the owner of the mineral property, subject, of course, to the allowance for depletion. In addition, the production costs attributable to producing the minerals used to satisfy the production payment will be deductible by the owner of the working interest in the year incurred. Thus, the owner of the working interest is placed in essentially the same position as persons in other industries who purchase business assets subject to a mortgage.

Where, in a lease of mineral property, a production payment is retained by the lessor, the payment is treated, insofar as the lessee is concerned, as if it were a bonus granted by the lessee to the lessor which is payable in installments. In other words, the lessee is required to capitalize the payments and then recover them through depletion. In the hands of the lessor, however, the production payment is treated in the same manner as under existing law (that is, as derived from an economic interest in the mineral property and thus includible in income subject to the deduction for percentage depletion).

It is contemplated that the regulations issued on this provision will make it clear that on a sale or other disposition (including an abandonment) of a mineral property burdened by a production payment carved out by the taxpayer, any unpaid balance of the production payment will be taken into account in computing the gain or loss on the sale or other disposition.

Effective date.—This provision applies with respect to mineral production payments created on or after August 7, 1969, other than pro-

duction payments created prior to January 1, 1971, pursuant to a binding contract entered into before August 7, 1969.

The Act also includes two transitional rules. Under the first transitional rule, a taxpayer is allowed to elect (at the time and in the manner prescribed by the Secretary of the Treasury or his delegate by regulations) to treat carved-out production payments which were sold during and after the taxpayer's last taxable year ending prior to August 7, 1969, in the manner prescribed by the Act; that is, the taxpayer may elect to treat these payments as loans rather than as sales. Since production payments created in the taxpayer's preceding taxable year can result in net operating losses in the current taxable year, this provision, in effect, allows taxpayers to undo net operating losses they had previously created. Any refund of, or credit for, a prior year's taxes which a taxpayer becomes entitled to by reason of this election is to be made without interest.

The second transitional rule provides in effect that the new rules contained in this provision do not apply to carved-out production payments sold during that part of the taxpayer's taxable year which occurs after August 6, 1969, to the extent the production payments offset a net operating loss which would otherwise occur in the taxable year in the absence of the carve-outs.

Specifically, it is provided that the new rules do not apply to carved-out production payments sold during the post-August 6 part of the taxpayer's taxable year to the extent the production payments are necessary to increase the taxpayer's gross income for the year to the amount of the taxpayer's deductions (other than the net operating loss deduction) for the year. The amount of carved-out production payments qualifying for this treatment, however, when added to the amount of carved-out payments sold by the taxpayer during the pre-August 7 part of his taxable year may not exceed the amount of carved-out production payments sold by him during the 12-month period prior to his taxable year (i.e., generally during his last taxable year ending before August 7, 1969). This treatment is not available for purposes of the percentage depletion provisions of the code or the limitations on the foreign tax credit.

Revenue effect.—It is estimated that this provision will result in an annual revenue increase of \$100 million in 1970, \$150 million in 1974, and \$200 million when fully effective.

5. Mining Exploration Expenditures (sec. 504 of the Act and secs. 615 and 617 of the code)

Prior law.—Under prior law, a taxpayer could elect to deduct, without dollar limitation, in computing taxable income, mining exploration expenditures (that is, expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or any mineral other than oil or gas) which were paid prior to the beginning of the development stage of the mine. This deduction was only allowed, however, with respect to mines located in the United States or on the Outer Continental Shelf. When a mine reached the producing stage, there was a recapture of the exploration expenditures previously deducted. This recapture was accomplished by disallowing the depletion deduction with respect to the mine to the extent of the previous deductions for exploration expenditures; that is, until the

amount of depletion disallowed equaled the exploration expenditures previously deducted. Alternatively a taxpayer could elect, when the mine reached the producing stage, to include in income the amounts previously deducted as exploration expenditures. Provision was also made for the recapture of the previous exploration deduction where the mining property was disposed of before there was a complete recapture through the disallowance of depletion.

A taxpayer who did not elect the unlimited deduction for mining exploration expenditures described above could elect to deduct a limited amount of exploration expenditures, whether on domestic or foreign mines, without the recapture rules applying. The total of the deductions allowed to any one taxpayer under this limited rule was \$100,000 a year, but for all taxable years the total could not exceed \$400,000. A taxpayer in this case could both write off the exploration expenditures currently and then, in addition, receive the full amount of depletion when the mine reached the producing stage, or receive capital gains treatment on the entire amount of the gain upon a sale of the mining property.

General reasons for change.—The Congress recognized that the allowance of a current deduction for mining exploration expenditures provides an incentive for hard mineral explorations. It concluded, however, that it was not necessary to allow both the current deduction of exploration expenditures and also depletion with respect to production in order to obtain the desired incentive. The general rule of prior law which allowed an unlimited deduction for mining exploration expenditures, but which provided for the subsequent recapture of these deductions—which it is believed most producers had used—is based on this principle. It was difficult for the Congress to find any basis for having the exception in prior law which allowed taxpayers to elect a current deduction for mining exploration expenditures (up to \$400,000) with no subsequent recapture.

The treatment of expenditures which are incurred during the development or producing stage of a mine also was of concern to the Congress. As indicated above, under prior law mineral exploration expenditures were currently deductible but subject to recapture, if they were incurred prior to the development stage of a mine. Expenditures incurred after the development stage of a mine has been reached also are currently deductible, either as development expenditures or operating expenses, but are not subject to recapture. It appears clear that Congress, in enacting these provisions of law, intended that exploration-type expenditures incurred during the development or producing stage of a mine would be treated as deductible development expenditures or operating expenses (except where the expenditures were made to discover a new mine), rather than as exploration expenditures. The Revenue Service, however, apparently supported by one circuit court case (*Santa Fe Pacific Railroad Co. v. United States*, 378 F. 2d 72 (7th Cir.)), has at times taken the view that these expenditures are not to be treated as development or operating expenses, but rather are to be considered as exploration expenditures which must be capitalized since they are incurred after the development stage of the mine has been reached.

The Congress intended to allow the deduction of *all* expenditures incurred by a taxpayer in bringing a mine into production, either as

exploration expenditures during the exploration stage or as development expenditures or operating expenses during the development and production stages. In other words, it is believed that under prior law and under the revisions which this Act makes, expenditures on a mine after the development stage has been reached are deductible development expenditures or operating expenses, unless the expenditures are made for the purpose of discovering a new mine. That is, if a mine is in the development or production stage, exploratory expenditures (drilling, crosscutting, etc.) to determine the location, extent or quality of a new deposit in the mine or to locate or find other veins of ore in the mine, are believed to be deductible without recapture. However, if the exploration project is for the discovery of a new mine, even though conducted from underground workings of an existing mine, it is believed that the expenditures should be treated as exploration expenditures. For example, if the operator of an existing mine enters into an agreement with the owner of adjacent lands to drive crosscuts from the bottom of the existing mine into the adjacent lands to find out whether there are deposits of ore which would "make a mine," it is believed that the exploration expenditures are appropriately subject to section 617 even though the agreement provides that the operator of the existing mine, if the exploration project is successful, will have a share in the new mine when it is developed.

Explanation of provision.—The Act provides that all mining exploration expenditures made after December 31, 1969, are subject to the general recapture rules of present law.

In addition, it is provided that taxpayers may continue to deduct expenditures for foreign (and oceanographic) explorations to the extent permitted under prior law. Thus, taxpayers generally may deduct expenditures for foreign explorations to the extent these expenditures do not exceed \$400,000, reduced by the aggregate of any amounts (whether for foreign or domestic exploration) previously deducted or deferred under the exploration expense provisions of prior law (either the limited or the general deduction). In addition, a taxpayer who elects for the first time to claim a current deduction for mining exploration expenditures is allowed to deduct expenditures for foreign explorations under the general deduction rule, subject to its recapture provisions, until the taxpayer's total deductions for mining exploration expenditures (whether domestic or foreign) equals \$400,000.

Under the Act, mining exploration expenditures made prior to January 1, 1970, which were deducted under the provision of prior law limiting the total deduction for exploration expenditures to a maximum of \$400,000 are not subject to recapture.

Taxpayers who have elected to deduct mining exploration expenditures under the provision of prior law which limits the total deduction to \$400,000 are deemed (unless they notify the Secretary of the Treasury or his delegate to the contrary) to have made an election to deduct exploration expenditures under the general provision, insofar as expenditures made after December 31, 1969, are concerned.

In essence, the Act extends to all mining exploration expenditures the concept that a taxpayer in the hard mineral industry should not be allowed to benefit from both a current deduction for exploration expenditures, and, in addition, depletion on the property when it

reaches the producing stage or capital gains treatment with respect to the property if it is sold. At the same time the Act continues the present privilege which taxpayers have of deducting exploration expenditures for foreign (and oceanographic) explorations up to the point where their exploration expenditure deductions total \$100,000.

Effective date.—The changes made by this provision apply with respect to mining exploration expenditures made after December 31, 1969.

6. Continental Shelf Areas (sec. 505 of the Act and sec. 638 of the code)

Prior law.—Prior law is not explicit as to whether for purposes of the exploration for, or exploitation of, natural resources in the continental shelf area of the United States (or a foreign country) over which it has exclusive rights under the principles of international law, that area is considered for U.S. tax purposes as a part of the country.

General reasons for change.—The development of natural resources in the continental shelf areas of the world makes the status of these areas for tax purposes of increasing importance. This status is important, for example, in determining the source of income from mining activities conducted in continental shelf areas and in the application of the foreign tax credit with respect to this income. As a result, the Congress thought it was appropriate to clarify the tax status of continental shelf areas.

Explanation of provision.—The Act provides that for purposes of applying the income and employment tax provisions of the code (including those relating to the source of income from personal services) with respect to mines, oil and gas wells and other natural deposits, the term “United States” when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to the territorial waters of the United States over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

The Act also adds a cross-reference to the provisions of the code dealing with withholding of tax on payments to nonresident aliens which makes it clear that wages or salaries received for personal services performed in connection with the exploration for a mine or oil or gas well on, or on a mine or oil or gas well located or being developed on, the Continental Shelf of the United States constitute income from sources within the United States.

It also is provided that the term “foreign country” (or possession) when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to the territorial waters of the country (or possession) over which the government of the country (or the U.S. Government in the case of a possession) has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. In the case of a foreign country, this rule applies only if the government of the country exercises, directly or indirectly, taxing jurisdiction with respect to the exploration and exploitation of the natural resources. The Act makes it clear, however, that a foreign country is not to be treated as contiguous to the United States by reason of these definitions.

7. Foreign Tax Credit With Respect to Certain Foreign Mineral Income (sec. 506 of the Act and sec. 901(e) of the Code)

Prior law.—A U.S. taxpayer is allowed a foreign tax credit against his U.S. tax liability on foreign income. Generally, the amount of the credit is limited to the amount of U.S. tax on the foreign income.

There are two alternative formulations of the limitation on the foreign tax credit: the "per country" limitation and the "overall" limitation. Under the per country limitation, foreign taxes and income are considered on a country-by-country basis. Under the overall limitation, on the other hand, all foreign taxes and foreign income are aggregated. Thus, under this latter limitation, foreign taxes in one country, in effect, can be averaged with lower foreign taxes in another foreign country.

General reasons for change.—U.S. taxpayers who extract minerals in foreign countries are allowed a deduction for percentage depletion in computing their U.S. income tax. Because of the allowance by the United States of percentage depletion to the mineral-producing industries, the U.S. tax payable on these operations is often lower than the foreign tax payable on the income from the same operations. To the extent foreign tax paid or accrued on foreign income derived from the extraction of minerals from mines, wells, or other natural deposits exceeds the U.S. tax on the same income, the excess foreign tax, under prior provisions relating to the allowance of foreign tax credits, was available as a credit against U.S. tax otherwise payable on foreign source income from unrelated activities of the taxpayer in the same or, if the overall limitation has been elected, other foreign countries.

To prevent continuance of this benefit, which is available only to U.S. taxpayers who are engaged in the business of operating foreign mines, wells, and other natural deposits, it is generally provided that excess foreign tax credits attributable to the allowance of percentage, rather than cost, depletion by the United States on income from a foreign country are not to be allowed as a tax credit against U.S. tax otherwise payable on income from the taxpayer's nonmineral foreign activities.

Explanation of provision.—For purposes of computing foreign tax credits available to a U.S. citizen or domestic corporation who claims a deduction for percentage depletion, the Act requires a taxpayer to divide his income into two parts: first, "foreign mineral income" from sources within each foreign country, and second, income from all other sources.

For purposes of this provision, "foreign mineral income" is defined as income derived from the extraction of minerals from mines, wells, or other natural deposits, income from the processing of such minerals into their primary products, and income from the transportation, distribution, and sale of the primary products derived from the mineral or of the mineral itself. Thus, for example, an integrated oil company is to treat its entire income from the production of oil, income attributable to the refining of crude oil into gasoline, income from the distribution of gasoline to marketing outlets, and its income from retail sales of gasoline as foreign mineral income. Similarly, income from the refining, distribution, and marketing of fuel oil by the taxpayer is also treated as mineral income for this purpose, whether or not the oil sold was extracted by the taxpayer. However, income

attributable to the manufacture, distribution, and marketing of petrochemicals is not to be treated as mineral income. In addition to treating certain operating income as mineral income, the Act treats dividends from corporations with respect to which taxpayers may claim a deemed paid foreign tax credit as foreign mineral income to the extent the dividend is attributable to mineral activities of the payor corporation. The Act also provides that the portion of a taxpayer's distributable share of income of a partnership is treated as foreign mineral income to the extent it is derived from foreign mineral activities of the partnership.

Once the income of a taxpayer is divided into the mineral and non-mineral categories, the Act provides for a disallowance of taxes paid or accrued to a foreign country as a credit against U.S. tax to the extent the excess of that foreign tax over the U.S. tax on the mineral portion of the taxpayer's income from that foreign country is attributable to the allowance of percentage, rather than cost, depletion for U.S. income tax purposes. This disallowance occurs prior to the application of the general foreign tax credit limitations. Thus, if a foreign tax is disallowed under this provision in the year paid or accrued, it is not permitted to be treated as a carry back or a carry forward to another taxable year.

This provision does not affect taxpayers who do not claim percentage depletion on income from extraction of foreign minerals. Moreover, it does not affect taxpayers who claim percentage depletion on such income for Federal income tax purposes if the tax paid to a foreign country which is allocable to their foreign mineral income from that country is equal to or less than the U.S. tax applicable to the same income assuming the taxpayer used cost, rather than percentage, depletion for U.S. tax purposes.

It also is provided that taxpayers who previously elected the overall limitation on the foreign tax credit may revoke that election without obtaining the consent of the Treasury Department for the taxpayer's first taxable year beginning after 1969.

Effective date.—This provision applies with respect to taxable years beginning after December 31, 1969.

R. CAPITAL GAINS AND LOSSES

1. Alternative Tax Rate for Individuals (sec. 511 of the Act and sec. 1201 of the code)

Prior law.—Under prior law, one-half of an individual's net long-term capital gains was included in taxable income and, accordingly, taxed at the regular tax rates. Thus, an individual's long-term capital gains usually were subject to tax at a rate that was one-half his marginal tax rate. Where, however, an individual's marginal tax rate was over 50 percent the alternative capital gains rate was applicable and these gains would be subject to a tax rate of 25 percent. In other words, the tax rate on long-term capital gains was 25 percent for married couples filing a joint return when their taxable income (including the half of capital gains which is includible in income) was greater than \$52,000 (\$26,000 in the case of the single persons). This same 25-percent tax rate was applicable whether the couple's other taxable income was \$53,000 or \$1 million.

General reasons for change.—In recent years, many high-income taxpayers have planned to take advantage of the lower 25-percent alternative capital gains tax rate and have revised their investment strategies to convert as much as possible of their income into capital gains. For these taxpayers, the alternative rate, in effect, operated as an exclusion which varied with the taxpayer's marginal rate. A taxpayer with a 70-percent marginal rate, for example, in effect included only 36 percent of his net long-term capital gains in his income. As a result, the portion of a taxpayer's capital gains income subject to tax varied according to his marginal tax rate—the higher the tax rate, the smaller the portion of the gains which was taxed. The alternative capital gains rate, therefore, appeared to be at variance with the intent of the progressive rate structure to tax individuals according to their ability to pay.

The effect of the alternative tax (together with a number of tax preferences) was to reduce the effective rate of tax on income at higher levels of income. As shown in the following table, among taxpayers who used the alternative tax rate, the effective tax rate (estimated at 31.6 percent in 1969 for adjusted gross incomes between \$100,000 and \$200,000) was higher than the estimated effective tax rate on higher income classes (which declined to 28.5 percent for taxpayers with adjusted gross incomes in excess of \$1 million).

TAX UNDER PRIOR LAW FOR RETURNS WITH ALTERNATIVE CAPITAL GAINS TAX, ESTIMATED 1969

[Dollar amounts in millions]

Adjusted gross income class	Tax	Tax liability as a percent of AGI plus the excluded ½ of long-term capital gains
Under \$20,000.....		
\$20,000 to \$50,000.....	\$300	30.4
\$50,000 to \$100,000.....	2,217	30.2
\$100,000 to \$200,000.....	2,368	31.6
\$200,000 to \$500,000.....	1,660	30.9
\$500,000 to \$1,000,000.....	703	29.9
\$1,000,000 and over.....	957	28.5
Total.....	8,204	30.5

Explanation of provision.—Under the Act, long-term capital gains above \$50,000 will no longer qualify for the 25-percent alternative capital gains rate beginning in 1970. This alternative rate will continue to be available, however, for the first \$50,000 of long-term capital gains. Transition rules in effect for the years 1970 and 1971 provide alternative capital gains rates above the 25-percent rate but still below the maximum rates which might otherwise apply in the absence of the alternative capital gains rate. Thus, the maximum rate of tax on long-term capital gains (applicable only above the level of the first \$50,000 of capital gains) is increased to 29.5 percent in 1970 (not including the applicable income tax surcharge) and to 32.5 percent in 1971. In 1972, the maximum rate applicable is simply one-half of the 70-percent maximum income tax rate, or 35 percent.

Elimination of the alternative tax (except for the first \$50,000 of net long-term capital gains) increases the effective tax on high-income

returns which have been using the alternative tax rate. Estimates based on 1969 returns indicate that under the new provision returns with adjusted gross income between \$500,000 and \$1 million will pay an average effective tax of 30.2 percent on adjusted gross income plus the excluded one-half of net long-term capital gains, compared with 29.9 percent with full use of the alternative tax under prior law. The effective tax rate on returns with adjusted gross income above \$1 million are expected to increase from 28.5 percent to 36.5 percent.

Effective date.—These changes apply to taxable years beginning after December 31, 1969. However, the 25-percent alternative capital gains tax rate continues to apply to (1) amounts received before 1975 under binding contracts in effect on October 9, 1969, (2) installment payments received before 1975 pursuant to sales made before October 10, 1969, and (3) distributions from corporations made prior to October 10, 1970, which are made pursuant to plans of complete liquidation adopted before October 10, 1969.

Revenue effect.—This provision is estimated to increase income tax liabilities by an estimated \$165 million in calendar year 1970, \$220 million in 1971, and \$275 million in 1972 and thereafter.

2. Alternative Tax Rate for Corporations (sec. 511 of the Act and sec. 1201 of the code)

Prior law.—Under prior law, corporations that had an excess of net long-term capital gains over net short-term capital losses could use the “alternative tax,” which taxed the entire excess net long-term capital gains at 25 percent. Since the corporate tax structure is not graduated (as is the case for individuals) but is computed on the basis of a normal tax of 22 percent of taxable income and a surtax of 26 percent of that part of the taxable income which exceeds \$25,000, usually only those corporations with taxable incomes in excess of \$25,000 (on which the tax rate would be 48 percent, apart from the effect of the surcharge) used the alternative tax.

General reasons for change.—Because it limited the availability of the alternative capital gains tax for individuals, Congress decided it would also be appropriate to raise the corporate alternative capital gains tax rate. Moreover, it is not clear that a corporation’s capital gains are essentially different from its other business income. In addition, since corporations are not subject to graduated tax rates, they usually do not encounter the problem of having bunched income which has accrued over more than a one-year period and which is taxed in one year at steeply graduated rates.

Explanation of provision.—The alternative capital gains rate which is applied to a corporation’s net long-term capital gains is increased to 28 percent in 1970 and to 30 percent in 1971 and later years. These rates do not include income tax surcharges that may apply during those years.

Effective date.—These changes apply to taxable years beginning after December 31, 1969. However, the 25-percent alternative capital gains tax rate continues to apply to (1) amounts received before 1975 under binding contracts in effect on October 9, 1969, (2) installment payments received before 1975 pursuant to sales made before October 10, 1969, and (3) distributions from corporations made prior to October 10, 1970, which are made pursuant to plans of complete liquidation adopted before October 10, 1969.

Revenue effect.—It is estimated that this provision will increase income tax liabilities by \$105 million in calendar year 1970 and \$175 million in calendar year 1971 and thereafter.

3. Capital Losses of Individuals (sec. 513 of the Act and secs. 1211(b), 1212(b), and 1222(9) of the code)

Prior law.—Both individual and corporate taxpayers may deduct capital losses to the extent of their capital gains. In addition, under prior law, if an individual's capital losses exceeded his capital gains, he could deduct on a dollar-for-dollar basis up to \$1,000 of the excess losses against his ordinary income, and any remaining loss could be carried forward (for an unlimited number of years) and deducted against ordinary income (with the \$1,000 limitation applicable for that year) to the extent that the loss was not offset by capital gains. On the other hand, when an individual has a net long-term capital gain rather than a net capital loss, a maximum of one-half of the net long-term capital gain is subject to tax.

If a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they had been realized by only one taxpayer and are offset against each other with the \$1,000 limitation on the offset of ordinary income applicable to the combined net capital loss. On the other hand, under prior law, when both spouses had capital losses and filed separate returns, each spouse was allowed to deduct up to \$1,000 of net capital losses from ordinary income. Thus, by filing separately, it was possible for a married couple to receive a total capital loss deduction of \$2,000 against ordinary income.

General reasons for change.—The prior treatment of long-term capital losses was inconsistent in the case of individuals with the treatment of their long-term capital gains. A maximum of 50 cents of each \$1 of net long-term capital gains is subject to ordinary income tax. However, when capital losses exceeded capital gains, the excess loss was deductible dollar-for-dollar against ordinary income (up to a maximum of \$1,000).

It also appeared inappropriate to treat married couples as one taxpayer for most purposes but to treat them as two separate taxpayers where capital losses arise, with the result that each spouse was allowed to deduct up to \$1,000 of capital losses from ordinary income. The prior treatment of losses also provided persons living in community property States with an advantage over those living in noncommunity property States. In community property States, husbands and wives filing separate returns are automatically eligible for the benefit of the double loss deduction since gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law. In contrast, spouses living in noncommunity property States must have separate losses in order to claim them on separate returns.

Explanation of provision.—The Act makes two changes in prior law. First, it provides that only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. The \$1,000 limitation on the amount of capital losses which may be deducted from ordinary income continues to apply. However, \$2,000 of net long-term capital losses is now required to offset \$1,000 of ordinary income.

Second, the Act provides that the deduction of capital losses against ordinary income for married persons filing separate returns is limited to \$500 for each spouse (in place of the \$1,000 allowed under prior law).

The limitation on the deduction of net long-term capital losses provided by the Act may be illustrated in the following manner as it applies to a married couple filing a joint return. For any year beginning after the effective date of the Act, if the excess of the taxpayer's net long-term capital losses over his net short-term capital gains for the current year is \$2,000 or less, then only 50 percent of the excess is deductible against ordinary income in the current year, and no amount of the loss would remain to be carried over to future years. If the excess of the taxpayer's net long-term capital loss over his net short-term capital gain in the current year is more than \$2,000, he is allowed to deduct \$1,000 from his ordinary income for the current year (using \$2,000 of net long-term capital loss for this purpose), and the portion of the excess net long-term capital loss over \$2,000 can be carried over to a succeeding year and treated as a long-term capital loss in that year.

Capital losses arising in taxable years prior to the effective date of the Act continue to be treated as under prior law. Also, net short-term capital losses continue to be deductible in full against ordinary income subject to the \$1,000 limit. The Act does not (in this context) affect the treatment of capital losses of corporate taxpayers, since corporations are not allowed to deduct capital losses from ordinary income.

Effective date.—These amendments are effective for taxable years beginning after December 31, 1969.

Revenue effect.—These changes in the treatment of long-term capital losses incurred by individuals are estimated to increase revenue \$50 million in calendar year 1970 and \$65 million a year in the long run.

4. Capital Loss Carrybacks for Corporations (sec. 512 of the Act and secs. 1212(a), 381(b)(3), 6411, 6501, 6511(d), 6601(e), and 6611(f) of the code)

Prior law.—Both corporations and individuals may carry net operating losses back 3 years and forward 5 years. In the case of capital losses, however, an unlimited loss carryover is available for individuals and a 5-year capital loss carryover is available for corporations. Under prior law, no carryback of capital losses was available either for individuals or for corporations.

Capital losses which presently may be carried forward to other years are first offset against capital gains realized in those years. Any losses remaining after this offset may, in the case of individuals, be offset against ordinary income generally to the extent of \$1,000 a year. In the case of corporations, however, prior law permitted capital losses to be offset only against capital gains.

General reasons for change.—Congress in the past has found that a carryback of a net operating loss was often more beneficial to a corporation than a carryforward. A carryback frequently results in an almost immediate refund of tax paid in prior years, whereas a carryforward of a loss merely offers the prospect of a lesser tax at some time in the future. Therefore, when the carryback provision is used, money is made available closer to the time when the loss occurred and this often helps to provide relief for a taxpayer from the con-

sequences of having incurred the loss. A similar situation exists in the case of capital losses for corporations. In the case of individuals, however, the problem is different because the loss in part is allowed against ordinary income.

Explanation of provision.—The Act provides a 3-year capital loss carryback for a net capital loss of a corporation for any taxable year. This carryback provision is not available for foreign expropriation capital losses for which a special 10-year carryforward (in lieu of the regular 5-year carryforward) is available.

This provision also is not available for a net capital loss arising in a year for which a corporation is treated as an electing subchapter S corporation (i.e., an electing small business corporation under section 1372); nor can a net capital loss of a corporation be carried back to a taxable year for which the corporation was treated as a subchapter S corporation. If any of a corporation's three years immediately preceding the current year were years for which it was treated as a subchapter S corporation, then the number of years for which a carryback is available is reduced by that number. For example, if a corporation was treated as a subchapter S corporation in 1973 but not in 1972 or 1974, and if it sustained a capital loss in 1975, then it could carry the loss back to 1972 and 1974, but not to 1973.

A rule (sec. 381(b)(3)), which presently applies with respect to the carryback of a net operating loss generally in the case of tax-free corporate acquisitions, is applied by the Act to the carryback of a net capital loss. Under this rule, a corporation acquiring property in a distribution (or transfer) of the type specified, may not carry back a net capital loss for a year ending after the date of distribution (or transfer) to a taxable year of the distributor (or transferor) corporation. Such a post-acquisition net capital loss, however, can be carried back by the acquiring corporation to its own preacquisition taxable years.

Taxpayers filing for refunds with respect to net operating loss carrybacks may obtain so-called "quickie" refunds. Under this procedure, the refund is made after only a preliminary check by the Internal Revenue Service on the appropriateness of the refund. (Subsequently, a full examination is made by the Service of the refund under its regular auditing procedures.) The Act applies this same "quickie" refund procedure in the case of the 3-year capital loss carrybacks.

Effective date.—These amendments apply to net capital losses sustained in taxable years beginning after December 31, 1969.

Revenue estimate.—The revenue loss as a result of this provision is expected to be small.

5. Collections of Letters, Memorandums, Etc. (sec. 514 of the Act and secs. 1221(3) and 1231(b)(1)(C) of the code)

Prior law.—Copyrights and literary, musical or artistic compositions (or similar property) are excluded from the definition of a capital asset, if they are held by the person whose efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, gain arising from the sale of such a book, artistic work, or similar property is treated as ordinary income, rather than as capital gain. Under prior law, however, collections of letters, memorandums, etc. (including those prepared by or for, directed to, or given to, the individual) were not specifically excluded from

the definition of a capital asset, and gains from the sale of such property were therefore accorded capital gains treatment.

General reasons for change.—The rationale underlying the treatment of a copyright, artistic work, and similar property in the hands of the person who created it (or in the possession of a person who received the property as a gift from the person who created it) is that the holder of the property is, in effect, engaged in the business of creating and selling the artistic work or similar property (or is selling property created by the personal efforts of another who gave him the property). In view of this, gain arising from the sale of such property is treated as ordinary income derived as compensation for personal services rendered by the person (or the contributor), rather than as a capital gain from the sale of property held as a capital asset.

The Congress concluded that letters, memorandums, papers, etc. (or collections thereof) are essentially similar to literary or artistic compositions created by the personal efforts of the taxpayer (or of the person who gave the property to the taxpayer), and should, therefore, be classified in the same manner for purposes of the tax law. A person who sells a book written by or for him is treated as receiving ordinary income for the product of personal efforts (i.e., compensation for personal services rendered). The Congress believed that one who sells a letter or memorandum written by or for him should not be treated as receiving capital gain on the sale when the product he is selling is, in effect, the result of personal efforts.

Explanation of provision.—The Act provides that letters, memorandums, and similar property (or collections thereof) are not to be treated as capital assets, if they are held by a taxpayer whose personal efforts created the property or for whom the property was prepared or produced (or by a person who received the property as a gift from the person who created or prepared it). For this purpose, letters and memorandums addressed to an individual are considered as prepared for him. Gains from the sale of these letters and memorandums, accordingly, are treated as ordinary income, rather than as capital gains.¹

Effective date.—The amendments made by this provision are applicable with respect to sales and other dispositions occurring after July 25, 1969.

Revenue effect.—The revenue effect of this provision is small.

6. Total Distributions From Qualified Pension, Etc., Plans (sec. 515 of the Act and secs. 402(a), 403(a)(2), and 72(n) of the code)

Prior law.—An employer who establishes a qualified employee pension, profit-sharing, stock bonus, or annuity plan is allowed to deduct contributions to the trust, or if annuities are purchased, may deduct the premiums. The employer contributions generally are not taxed to the employee until the amounts credited to his account are distributed or “made available” to him. In addition, income earned by the trust—or the earnings on reserves set aside by an insurance com-

¹ Since in the case of charitable contributions of ordinary income property the unrealized appreciation in the contribution has the effect of limiting the charitable contribution deduction under another provision in this Act to the cost or other basis of the property, the treatment of these letters, memorandums, etc., as giving rise to ordinary income has an impact on the charitable contribution deduction available with respect to them under this other provision. The effect is that, to the extent papers, memorandums, etc., have no cost basis, no charitable contribution deduction is available with respect to gifts of such property. (See Sec. C. *Charitable Contributions*, above.)

pany for employee benefits—are exempt from tax if the employee trust is exempt (under sec. 501(a)).

Retirement benefits generally are taxed as ordinary income under the annuity rules (sec. 72) when the amounts are distributed, to the extent they do not represent a recovery of the amounts contributed by the employee. However, an exception to this general rule under prior law provided that if an employee's total accrued benefits were distributed or paid in a lump-sum distribution from a qualified plan within one taxable year on account of separation from employment or death (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than ordinary income.¹

An employee who received a lump-sum distribution of the type described above, which consists in whole or in part of securities of the employer corporation, was not taxed at the time of distribution on the net unrealized appreciation in the securities (that is, the difference between the current value of the securities and the amount paid for the securities by the qualified employee trust). Thus, an employee receiving employer securities was taxed at that time only on the amount attributable to the employer's cost at the time of his contribution to the trust. This amount was taxed at capital gains rates. The net unrealized appreciation was taxed as capital gain later when, or if, the stock was sold by the employee.

General reasons for change.—The capital gains treatment of lump-sum pension distributions was originally enacted in the Revenue Act of 1942 as a solution to the so-called bunched-income problem of receiving retirement benefits in one year which had accrued over several years.

However, the capital gains treatment accorded these lump-sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than other compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of \$50,000, particularly in view of the fact that a number of lump-sum distributions of over \$800,000 have been made.

Explanation of provision.—The Act provides that part of a lump-sum distribution received from a qualified employee's trust within one taxable year on account of separation from service or death (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. The ordinary income treatment applies to the taxable portion of the distribution (i.e., the total distribution less the employee's contribution) which represents the employer's contribution, but only to the extent the contributions accrue during plan years beginning after 1969. For this purpose, amounts forfeited by an employee and left in a trust are treated as contributions made by an employer. This treatment outlined above applies to employer contributions of employer securities as well as other amounts the employer contributes.

Capital gains treatment, in the case of these lump-sum payments, will continue to apply to future earnings of the trust or plan and future income attributable to appreciation on amounts contributed to the trust or plan. Of course, capital gains treatment will also apply to

¹ Self-employed persons receiving "H.R. 10" plan lump-sum distributions are taxed at ordinary income rates under a special 5-year averaging provision (sec. 72(n)(2)).

employer contributions to the extent they represent pension and annuity benefits accrued in plan years beginning before 1970. As under prior law, net unrealized appreciation in employer securities received in lump-sum distributions continue to be treated as a capital gain and is taxed only when the securities are sold at a gain.

The Act provides a special limitation in the form of a 7-year "forward" averaging formula which applies to the portion of the lump-sum distribution treated as ordinary income. This formula is broadly similar to the 5-year "forward" averaging provided for lump-sum pension distributions to self-employed taxpayers under "H.R. 10" type pension plans (sec. 72(n)(2)). An employee (or beneficiary) is eligible for the special 7-year forward averaging provision if the distribution is made on account of separation from service or death (or death after separation from service)² and if he has been a participant in the plan for 5 or more taxable years before the taxable year in which the distribution is made.

In computing the tax liability on the ordinary income portion of the lump-sum distribution under the 7-year averaging provision, employees (but not self-employed) may exclude certain types of income from the computation, but only if they are at least age 59½ by the year the distribution is received (or if they have died or become disabled within the meaning of sec. 72(m)(7)). The income which may be excluded for purposes of this computation is compensation received from the employer during the year³ and also the capital gains portion of the lump-sum distribution. Moreover, this amount treated as capital gains may also be omitted for purposes of the 7-year averaging calculation without regard to the employee's age or whether he has died or become disabled.

These special exclusions in making the calculations under the 7-year averaging rule are designed to prevent higher tax brackets from applying to the ordinary income portion of a lump-sum distribution merely because it is received in the final year of employment rather than the year following retirement when the taxpayer generally would not have salary or wage income from the employer. The exclusion of the capital gain portion from the base for making this calculation also precludes a higher tax bracket from applying to the ordinary income portion of the lump-sum distribution during the year of retirement due to the nonrecurring lump-sum distribution.

Effective date.—These provisions are effective for taxable years ending after December 31, 1969.

Revenue effect.—It is estimated that this provision will result in an increase in income tax liabilities of \$5 million in 1971 and \$60 million in the long run.

7. Sales of Life Estates, Etc. (sec. 516(a) of the Act and sec. 101 of the code)

Prior law.—When a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder

² Self-employed taxpayers, on the other hand, continue to be eligible for their special 5-year forward averaging only on lump-sum distributions received on account of death, disability as defined in sec. 72(m)(7), or if received after the age of 59½.

³ However, deferred compensation within the meaning of sec. 404 may not be so excluded for this purpose.

interest is increased in the same amount; hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant in this case is not permitted to amortize his basis over the period of the life estate and thereby reduce for tax purposes the amount of income he reports. However, under prior law, where the life tenant sold his right to receive future income, his basis in the property at the time of sale was used to reduce the gain he received on the sale. The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above had the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it. In addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In some cases the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

Explanation of provision.—In general, the Act provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the Act provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, in the type of situations considered here, there is no basis to be offset against the proceeds received on a disposition of this type of interest; and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

The Act does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. This exception appeared appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Effective date.—These amendments are effective for sales or other dispositions after October 9, 1969.

Revenue effect.—It is estimated this provision will result in an annual revenue increase of \$10 million.

8. Certain Casualty Losses Under Section 1231 (sec. 516(b) of the Act and sec. 1231(a) of the code)

Prior law.—Generally, under existing law (sec. 1231(a) of the code), if the gains on the disposition of certain types of property exceed the losses on this same type of property, in effect, the excess is treated as long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The long-term gains or losses generally taken into account for purposes of this computation of net capital gains or net ordinary losses include recognized gains or losses from:

- (1) sales or exchanges of depreciable property and real estate used in a trade or business; and
- (2) the compulsory or involuntary conversion of capital assets held for more than 6 months and depreciable property and real estate used in a trade or business.

Other gains taken into account for this computation include certain gains from timber, coal, iron ore, livestock, and unharvested crops.

The Technical Amendments Act of 1958 provided an exception to the rule described above. It provided that an uninsured loss on property (held for more than 6 months) resulting from fire, storm, shipwreck, or other casualty, or from theft, was not to be offset against gains treated as capital gains (that is, was not to be classified as a sec. 1231 loss) if the property was used in the taxpayer's trade or business (or was a capital asset held for the production of income.) Thus, as a result of the 1958 amendment, these uninsured losses were deductible under prior law against ordinary income and were not required to be offset against gains which otherwise are treated as long-term capital gains. In other words, the 1958 amendment provided an exception to the general rule of section 1231 that the overall gain or loss position of the taxpayer under the section determines whether a loss is deductible against ordinary income or whether it must be used to offset what otherwise would be a capital gain.

General reasons for change.—The exception to the general section 1231 rule has led to anomalous results. On the one hand, a business taxpayer with a casualty loss on two similar business properties, one of which is insured and one of which is not, is allowed to deduct the loss on the uninsured property in full against ordinary income and at the same time is allowed to treat the gain on the insured property (the excess of the amount of insurance received over his adjusted basis in the property) as a capital gain. In other words, although this situation would appear to be squarely within the basic concept of section 1231 which requires losses to be netted against gains, such a netting is not required in this situation and, thus the loss rather than reducing the capital gain is deductible in full from ordinary income.

On the other hand, the basic offsetting of gains and losses is required where a business taxpayer only partially insures a business property. Thus, if a business taxpayer has a casualty loss on a business property which is only partially, perhaps 5 percent, insured, the deductibility of the loss against ordinary income is determined by the basic sec-

tion 1231 rule which looks to the overall gain or loss position of the taxpayer. As indicated, however, if the property had not been insured at all, the loss would have been fully deductible against ordinary income without regard to the taxpayer's overall gain or loss position under section 1231.

The Congress concluded that the present distinction under section 1231 between insured and partially insured casualty losses is unrealistic. It also concluded that it was not appropriate to allow a business taxpayer to deduct an uninsured casualty loss on business property in full from ordinary income when he also has a larger casualty gain on insured business property which is treated as a capital gain.

Another problem also arose under section 1231 involving the basic scope of the section; namely, whether it was applicable to casualty losses on uninsured personal assets, such as a taxpayer's personal residence or nonbusiness automobile. The 1958 amendment does not apply if the destroyed property, whether or not completely uninsured, is a capital asset not held for the production of income or, in other words, a personal asset. In enacting this amendment, it appears Congress believed these uninsured casualty losses were subject to section 1231 and thus had to offset capital gains under the section, rather than being fully deductible against ordinary income.

Section 1231, however, has been interpreted by some courts to mean that a casualty loss is not subject to the provisions of that section unless the taxpayer receives some property or money as compensation for the loss. The effect of this line of reasoning is to treat uninsured losses with respect to a taxpayer's personal assets, such as his residence or nonbusiness automobile, as fully deductible against ordinary income, rather than being required to offset under section 1231 what otherwise would be long-term capital gains.

Explanation of provision.—The Act modifies the treatment of casualty losses and casualty gains under section 1231. Under the Act, casualty (or theft) losses on depreciable property and real estate used in a trade or business and on capital assets held for 6 months must be consolidated with casualty (or theft) gains on this type of property. If the casualty losses exceed the casualty gains, the net loss, in effect, is treated as an ordinary loss (without regard to section 1231). On the other hand, if the casualty gains equal or exceed the casualty losses, then the gains and losses are treated as section 1231 gains and losses which must then be consolidated with other gains and losses under section 1231.

This consolidation rule applies whether the casualty property is uninsured, partially insured, or totally insured. In addition, it applies in the case of casualty property which is a capital asset held for 6 months whether the property is business property, property held for the production of income or a personal asset.

The Act also clarifies the fact that uninsured casualty losses on a taxpayer's personal assets, such as his personal residence or nonbusiness automobile, are subject to the basic section 1231 provisions.

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

Revenue effect.—The revenue effect of this provision is small.

9. Transfers of Franchises, Trademarks, and Trade Names (sec. 516(c) of the Act and sec. 1253 of the code)

Prior law.—Questions arose under prior law and court cases as to whether the transfer of a franchise, trademark, or trade name was to be treated as a sale or license, and whether the transferors were selling franchises, trademarks, or trade names in the ordinary course of business. Since prior law did not deal specifically with these questions, the problems had to be resolved under general tax principles. This produced different results (i.e., capital gains treatment in some situations and ordinary income treatment in others), despite factual similarities in the interests in the franchises, trademarks, or trade names transferred. The decisions generally have been based on the degree to which the transferor reserved significant powers, rights, or continuing interests in the operation of the interest transferred. If the total reservations were interpreted to be of significant nature, such reservations generally precluded the finding of a sale and resulted in ordinary income treatment for part or all of the payments received by the transferor.

Frequently, part of the payments made to the transferor are payable over a period of time and are measured by a percentage of the selling price of the products sold or based on the units manufactured or sold, or some other similar method contingent upon production, sale, or use. Some courts have treated this form of transfer as if it were not a sale (i.e., as a license arrangement), which has resulted in ordinary income treatment for the payments. Other courts, however, have not regarded the form of payment to be controlling, and have considered all such payments as a capital gain.

Questions have also arisen as to the deductibility of amounts paid (initial fees or contingent payments) by the transferee to the transferor, depending on whether the transfer agreement is considered to be a sale or license.

General reasons for change.—Prior law did not specifically deal with the transfer of a franchise, trademark, or trade name, and there was a considerable diversity of opinion among courts as to whether such a transfer constituted a sale or license, and whether part or all of the transfer was a sale of a capital asset. For example, the Tax Court held on several occasions that the transfer of franchises was not a sale for tax purposes because of certain retained powers, rights, or continuing interests by the franchisor with respect to the franchise operation, which was considered to be inconsistent with a sale or exchange of property. Substantial participation in the management of the transferee's business activities and operations has also been a factor in the court's decisions in precluding the finding of a sale. Gains from such transactions were therefore considered to be ordinary income. This position of the Tax Court has been accepted generally by two circuit courts of appeals; however, three other circuit courts of appeals have found sales to exist in similar transactions, and have allowed franchisors capital gains treatment.

A somewhat similar conceptual problem exists with respect to transfers of trademarks and trade names. Further, it appeared that the question of the deductibility of amounts paid (initial fees and contingent payments) by transferees to transferors of franchises, trademarks, or trade names needed clarification.

Explanation of provision.—The Act provides that the transfer of a franchise, trademark, or trade name is not to be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name. Thus, a transferor does not receive capital gains treatment in these cases. If the transfer agreement includes significant conditions or restrictions which are subject to the transferor's approval on a continuing basis, this power to exercise continuing, active, operational control over the transferee's business activities is considered as a retention by the transferor of a significant power, right, or continuing interest. Moreover, if the transferor's conduct constitutes participation in the general management or economic activities of the transferee's business, then this also is regarded as a retention of a significant power, right, or continuing interest.

The concept of a "significant power, right, or continuing interest" includes, but is not to be limited to: (A) a right to disapprove any assignment or any part thereof; (B) a right to terminate at will; (C) a right to prescribe the standards of quality of products used or sold or of services furnished, and of the equipment and facilities used to promote such products or services; (D) a right to require that the transferee sell or advertise only products or services of the transferor; (E) a right to require that the transferee purchase substantially all of his supplies and equipment from the transferor; and (F) a right to payments contingent on the productivity, use or disposition of the subject matter, if such payments constitute a substantial element under the transfer agreement.

The Act provides that all amounts received or accrued by the transferor on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred are to be treated as ordinary income. Contingent payments would include continuing payments (other than installment payments of a principal sum agreed upon in the transfer agreement) measured by a percentage of the selling price of products marketed or based on the units manufactured or sold, or any other similar method based upon production, sale or use, or disposition of the franchise, trademark, or trade name transferred.

The Act also provides that amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred, are deductible by the transferee as trade or business expenses.

In addition, the Act provides rules for the treatment of initial payments (including a lump-sum or fixed amount payable in installments) made by a transferee to a transferor with respect to a franchise, trademark, or trade name agreement, determining the treatment by reference to whether the agreement constitutes a sale or a license. Where it is a sale, the transferee continues to be treated as under present law; that is, if he has purchased an intangible asset without an ascertainable useful life, he is not entitled to deductions for the lump-sum payment or installment payments to the transferor. (Of course, the franchise, trademark, or trade name may have an ascertainable life in the circumstances of a particular case.)

Where, however, the agreement is not a sale under this provision, then the transferee may deduct the initial payments over the period of the agreement to which they are attributable or over a period of 10 taxable years, whichever is less. This treatment applies in these cases to any payment, other than a contingent payment, in discharge of a principal sum agreed upon in the transfer agreement. Thus, in the case of a single payment, the transferee is allowed to deduct the payment ratably over 10 years if the transfer agreement is for a period of more than 10 years, or ratably over the period of agreement, if the agreement is not more than 10 years. If approximately equal payments in discharge of the principal sum are payable over the period of the transfer agreement (or a period of more than 10 taxable years, whether ending before or after the period of the transfer agreement), the payments may be deducted in the taxable year made. The Treasury is to provide consistent rules for the deduction of other methods of payment of the principal sum.

In the case of transfers of franchises, trademarks, or trade names before the effective date of this provision, the transferee may elect to deduct contingent payments which would be deductible under the new rules as if the transfer had occurred after the effective date of the provision. This is only to be available, however, with respect to contingent payments made in taxable years ending after December 31, 1969 and beginning before January 1, 1980, with respect to transfers before the effective date.

For purposes of this provision, a "transfer" is to include a transfer of any interest (i.e., a part) in a franchise, trademark or trade name, and the term "transfer" also includes the renewal of an existing franchise, trademark, or trade name agreement.

The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. This includes distributorships or other similar exclusive-type contract arrangements to operate or conduct a trade or business within a specified area, such as a geographical area to which the business activity of the transferee is limited by the agreement. However, the Act provides that the new rules are not to apply to the transfer of a franchise to engage in a professional sport. This exception applies only to franchises for teams to participate in a professional sports league, and would not apply to other franchised sports enterprises, such as a franchise to operate a golfing, bowling, or other sporting enterprise as a trade or business.

The term "trademark," as defined in section 45 of the Trademark Act of 1946, "includes any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others." The term "trade name" under this provision includes a trade brand.

Effective date.—This provision applies to transfers after December 31, 1969.

Revenue effect.—The revenue effect of this provision is small.

S. REAL ESTATE DEPRECIATION

(Sec. 521 of the Act and secs. 167 and 1250 of the code)

Prior law.—Prior law (since 1954) provided that new real property and new tangible personal property could be depreciated by the first owner under either the double declining balance method or the sum of the years-digits method of depreciation. These methods generally permit large portions of an asset's total basis to be deducted in the first few years of the asset's useful life. A later owner was permitted to use the 150-percent declining balance method, which is significantly "faster" than straight line in the early years, but significantly "slower" than the two other methods referred to above.

In the case of sales of property used in the trade or business, net gains (with certain exceptions) were taxed as capital gains, and losses were treated as ordinary losses. In 1962, this was modified as to most personal property and certain real property to provide in general for taxing gain on sale as ordinary income to the extent of all the depreciation taken on that property after December 31, 1962. In 1964 the rules were modified as to buildings to provide in general for taxing gain on sale as ordinary income to the extent of certain depreciation taken after December 31, 1963; however, after the property was held 12 months, only depreciation in excess of straight line was "recaptured" and taxed as ordinary income and that amount was reduced after 20 months, at the rate of 1 percent per month for 100 months, after which nothing was recaptured.

General reasons for change.—The prior tax treatment of real estate was used by some high-income individuals as a tax shelter to escape payment of tax on substantial portions of their economic income. The rapid depreciation methods allowed made it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. Moreover, because accelerated depreciation usually produced a deduction in excess of the actual decline in the usefulness of property, economically profitable real estate operations were normally converted into substantial tax losses, sheltering from income tax economic profits and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Later, the property could be sold and the excess of the sale price over the remaining basis could be treated as a capital gain to the extent that the recapture provisions did not apply. By holding the property for 10 years before sale, the taxpayer could arrange to have all the gain resulting from excess depreciation (which was previously offset against ordinary income) taxed as a capital gain without the recapture provisions coming into play. The tax advantages from such operations increased as a taxpayer's income moved into the higher tax brackets.

Because of the tax situation, when investment was solicited in a real estate venture it became the practice to promise a prospective investor substantial tax losses which could be used to diminish the tax on his income from other sources. Thus, there was, in effect, substantial dealing in "tax losses" produced by depreciable real property.

In addition to the tax shelter aspect of the prior law depreciation allowances in the case of individuals, problems were also raised as to whether these allowances constituted an undue incentive for commercial and industrial construction.

Explanation of provision.—The Act contains provisions designed to substantially reduce the opportunities to avoid taxes as a result of accelerated depreciation for real estate. It provides that new construction, other than residential housing, is to be limited to 150-percent declining balance depreciation. New residential housing continues to be eligible for the double declining balance or sum of the years-digits depreciation methods. For this purpose a building is considered to be residential housing only if 80 percent or more of the gross income from the building in the year is derived from rentals of residential units.

The new rules curtailing accelerated depreciation on new real estate construction apply unless (1) the construction of the building began before July 25, 1969, or (2) a written contract with respect to any part of the construction or for a substantial portion of the permanent financing was entered into before July 25, 1969.

The Act allows accelerated depreciation in the case of construction of residential housing in foreign countries only to the extent that the foreign country allows accelerated depreciation on similar housing.

To eliminate the repeated sale and resale of property for the purpose of tax minimization, used realty (other than used residential property) acquired after July 24, 1969, is generally limited to straight line or a comparable ratable method of depreciation. Used residential property with a useful life of 20 years or more, acquired after July 24, 1969, is limited to 125-percent declining balance depreciation. However, used property acquired after July 24, 1969, pursuant to a written contract for the acquisition of the property or for its permanent financing, which was binding on that date, continues to be eligible for the 150-percent declining balance depreciation permitted under prior law.

To encourage rehabilitation of buildings for low- and moderate-income rental housing, the Act allows taxpayers to elect to compute depreciation on rehabilitation expenditures which are made after July 24, 1969, under the straight line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. This rapid depreciation is limited to expenditures made prior to January 1, 1975, in order to provide an opportunity for the Congress to evaluate the effectiveness and cost of the new incentive. It is available only for low-income rental housing where the dwelling units are held for occupancy for families or individuals of low or moderate income, consistent with the policies of the Housing and Urban Development Act of 1968. The 60-month rule does not apply to hotels, motels, inns, or other establishments, where more than one-half of the units are used on a transient basis.

To qualify for the 60-month depreciation, the aggregate rehabilitation expenditures as to any housing may not exceed \$15,000 per dwelling unit and the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed \$3,000 per rental unit.

The Act generally tightens the recapture rules applicable to the sale of real estate, which are designed to tax the gain from such sales as ordinary income rather than capital gain to the extent that they represent deductions taken under accelerated depreciation in excess of straight line depreciation. Except in the case of residential real property (and certain pre-existing contracts) gains from the sale of

real property after December 31, 1969, are subject to recapture to the extent of the excess depreciation taken after December 31, 1969, without any percentage reductions for the holding period. The recapture rules of previous law (which reduce the amount subject to recapture by one percentage point for each full month the property is held more than 20 months) are retained (1) for sales made under a written contract which was binding on July 24, 1969, and thereafter, (2) for Federal, State, and locally assisted projects, which are limited as to rate of return on the investment, such as the FHA 221(d)(3) and the FHA 236 programs, and which are constructed, reconstructed or acquired before January 1, 1975, and (3) with respect to excess depreciation taken for periods before January 1, 1970.

For residential housing (other than that described in the preceding sentence), and also property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, the prior recapture rules are tightened to allow a one percent per month reduction in the amount to be recaptured as ordinary income after the property has been held for 100 full months.

Effective date.—The changes applicable to real estate are effective for taxable years ending after July 24, 1969.

Revenue effect.—The net revenue effect of these changes is small in calendar year 1970. However, in the long run, the changes in depreciation and recapture provisions together are estimated to increase annual revenue by \$1,260 million, while the rapid depreciation of rehabilitation expenditures reduces annual revenue by \$330 million.

T. SUBCHAPTER S CORPORATIONS

(Sec. 531 of the Act and sec. 1379 of the code)

Prior law.—Subchapter S was enacted in 1958 to permit the incorporation of small businesses (those with 10 or fewer shareholders) for business purposes without being subject to corporate tax. Instead, the shareholders of subchapter S corporations are taxed in a pattern roughly similar to the way in which partners are taxed. This election was granted in order to minimize the effect of Federal income taxes on businessmen's choices of the form of organization in which they conduct their business.

The subchapter S provisions did not deal with employee retirement plans. Consequently, these subchapter S corporations could establish corporate retirement plans for the benefit of shareholders who are also employees of the corporation. Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans to benefit themselves. By electing subchapter S treatment, however, they could continue to avoid the corporate level of taxation but, nevertheless, could establish corporate retirement plans.

In 1962, Congress enacted the Self-Employed Individual Retirement Act (H.R. 10), permitting self-employed persons to be treated as employees of the businesses they conduct so that they may be covered under qualified employee retirement plans. These provisions, however, contain certain specific requirements as to proprietors and partners which limit tax-free contributions to 10 percent of the proprietor's or partner's earned income, or \$2,500, whichever is less. These rules, however, do not apply to corporations.

General reasons for change.—The H.R. 10 limitations on retirement income plans described above do not apply to corporations and so could be avoided by a proprietor or the partners of a partnership by forming a corporation, electing subchapter S treatment, and then becoming employees of the corporation while at the same time retaining many of the benefits of tax treatment as a partnership. By the same token, a business that had incorporated without contemplating a subchapter S election could avoid the burden of the corporate tax while retaining its broad corporate retirement plans.

Explanation of provision.—The Act provides limitations, similar to those contained in H.R. 10, with respect to contributions to retirement plans for those individuals who are “shareholder-employees” of corporations that have elected to be taxed under subchapter S. For these purposes, a shareholder-employee is an employee or officer who owns at any time during the taxable year more than 5 percent of the shares of the corporation’s stock, including ownership by application of family attribution rules (of sec. 318(a)(1)).

Under the Act, a shareholder-employee of a subchapter S corporation must include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his salary or \$2,500, whichever is less. Other employees who are shareholders but own 5 percent or less of the stock in the subchapter S corporation are not subject to this rule, and greater contributions may be made on their behalf without any amount being included in their income under this provision.

In contrast to the treatment of H.R. 10 plans, excess contributions on behalf of shareholder-employees do not have any effect on the qualified status of subchapter S corporation plans. However, these excess contributions are regarded as having been made by the corporation for the purpose of determining whether the plan is qualified.

The amount of the contribution which the Act requires a shareholder-employee to include in his income is treated as his contribution to the trust. At the time of his retirement or other separation from employment entitling him to receive the benefits from the plan, his contribution is to be recovered tax free according to the rules for the tax treatment of annuities. When he begins to draw his pension or annuity, the tax-free part of the distribution is generally spread evenly over his probable lifetime, and the exclusion remains the same no matter how long he lives. If he is entitled to receive a lump-sum distribution instead of an annuity, the amount treated as his contribution is considered his basis so that he will not be taxed again on that amount.

Where a shareholder-employee or his beneficiaries do not receive those amounts which had been included in his gross income, a deduction is allowed, equal to the amount previously included in income, in the year the employee’s (or his beneficiaries’) rights under the plan terminate. This may occur where the employee terminates his employment, thereby forfeiting his benefits under the plan, or where he or his beneficiaries are receiving payments from the plan but, because of the employee’s death, recover less in the aggregate than the amounts previously included in his gross income. In that situation, a deduction is allowed only for the amount not previously recovered.

The Act also requires, in the case of a stock bonus or profit-sharing plan, that the plan specify that any forfeitures of contributions that had been deducted in subchapter S years cannot benefit the shareholder-employees, except forfeitures of those contributions made in taxable years beginning before January 1, 1971. This requirement may be satisfied after the close of the taxable year if appropriate amendments to the plan are in effect by the 15th day of the third month following the close of that taxable year and they are effective for the entire period, beginning on the first day of that taxable year.

In the case of a stock bonus or profit-sharing plan, existing law limits contributions each year to 15 percent of the compensation paid to the employees under the plan. However, any "unused" portion of this limitation may (subject to other limitations) be carried forward and applied to contributions in following years. The Act denies these carry-forwards to a corporation from a year when the corporation was an electing subchapter S corporation if the amount otherwise would be carried to a nonelecting year. However, the carryforwards from a nonelecting year may be used by a subchapter S corporation in an electing year.

Effective date.—This provision applies to taxable years of a subchapter S corporation beginning after December 31, 1970.

Revenue effect.—The revenue effect of this provision is expected to be small.

U. ARBITRAGE BONDS (SEC. 601 OF THE ACT AND SEC. 103(d) OF THE CODE)

Prior law.—Arbitrage bonds generally are obligations issued to acquire other securities where the rate of return of the other securities produces a higher yield than the interest cost on the initial bond issue. Prior law did not specifically preclude the issuance of bonds for such purposes by State or local governments. However, questions were raised in such cases as to whether the bonds in reality were obligations of a State or local government if it used the proceeds from the acquired securities to secure the payments of the initial issue of bonds. As a result, the Internal Revenue Service in recent years had refused to rule whether bonds issued in such circumstances constituted tax-exempt State or local government bonds.

General reasons for change.—Some State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from the tax-exempt issues were employed to purchase Federal or other obligations whose higher-yield interest payments were not taxed in their hands. In such cases, it appeared that the State or local bonds were issued to derive arbitrage income from the investment of funds and not to carry on a government function.

Explanation of provision.—The Act provides for the taxation of arbitrage bonds issued by State or local governments. Arbitrage bonds are defined as obligations issued where all or a major part of the proceeds can be reasonably expected to be used (directly or indirectly) to acquire securities or obligations which may be reasonably expected, at the time of the issuance of the State and local obligation, to produce a yield which is materially higher than the yield on the State or local government bond issue.

Arbitrage bonds do not include issues where substantially all of the proceeds of the issue are reasonably expected to be used to provide permanent financing for real property used, or to be used, for residential purposes for the personnel of an educational institution of higher learning where the yield on the Government obligation at the time of issue is not expected to be substantially lower than the yield on the permanent financing.

An obligation is not treated as an arbitrage bond solely because the proceeds of the issue may for a temporary period be invested in higher yield securities or other obligations until the proceeds are used for the purpose for which the State or local government bonds were issued. Nor are obligations classified as arbitrage bonds where the proceeds of the Government issue may be invested in higher yield securities which are part of a reasonable reserve or replacement fund so long as this fund does not exceed 15 percent of the total issue (unless the issuer establishes that a higher amount is necessary).

Effective date.—This provision is effective with respect to obligations issued after October 9, 1969.

Revenue effect.—The direct revenue effect from taxation of the interest income from arbitrage bonds is expected to be negligible since the provision was expected to eliminate such issues in the future.

V. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES

1. Extension of Tax Surcharge at 5-percent Rate for First Half of 1970 (sec. 701 of the Act and secs. 51(a) and 963(b) of the code)

Prior law.—The Revenue and Expenditure Control Act of 1968 imposed a 10-percent surcharge on tax liabilities of individuals and corporations. The 10-percent surcharge initially would have expired after June 30, 1969, but in H.R. 9951, the 10-percent surcharge was extended for the period from July 1, 1969, through December 31, 1969.

General reasons for change.—The extension of the surcharge until the end of calendar year 1969 provided by H.R. 9951 helped to combat the inflationary pressures which had remained strong. However, the Congress concluded that the continuing inflationary pressures, taken together within the budgetary situation, required a further extension of the surcharge, but at a lower rate, through the first half of 1970.

Explanation of provision.—The surcharge on the tax liabilities of individuals and corporations was continued at a 5-percent annual rate for the period from January 1, 1970, through June 30, 1970. For the tax liabilities of a calendar year taxpayer, the surcharge is applied for the entire year rather than for one-half the year, which means that insofar as tax returns are concerned those for calendar 1970 will show a 2½-percent surcharge.¹ For withholding tax purposes, however, the surcharge is taken into account at a 5-percent rate with respect to wages and salaries paid in the first half of the calendar year. In the second half of the year, insofar as withholding is concerned, no surcharge is to be imposed.

¹ In the case of a fiscal year taxpayer the surcharge is at an annual rate of 10 percent for the period ending December 31, 1969, and at an annual rate of 5 percent for the period beginning January 1, 1970, and ending June 30, 1970. The rate for any fiscal year, only a part of which is in the 10 percent or 5 percent surcharge period, is determined by a proration of the two periods on a daily basis.

A conforming amendment is also made which relates to the required amount of minimum distributions which a domestic corporation must receive from its foreign subsidiaries in order to avoid including undistributed earnings of the foreign subsidiaries in its own income.

The above provisions apply to taxable years ending after December 31, 1969, and beginning before July 1, 1970.

Revenue effect.—The extension of the surcharge at a 5-percent rate for the period January 1, 1970, through June 30, 1970, is estimated to increase revenues by \$2.0 billion in fiscal year 1970 and by \$1.1 billion in fiscal year 1971.

2. Continuation of Excise Taxes on Communications Services and Automobiles (sec. 702 of the Act and secs. 4061(a)(2)(A) and 4251(a)(2) and (b) of the code)

Prior law.—The excise tax on passenger automobiles presently is 7 percent and the excise tax on local and toll telephone services and teletypewriter exchange services presently is 10 percent. Both rates were scheduled to decline to 5 percent on January 1, 1970, 3 percent on January 1, 1971, one percent on January 1, 1972, and to be repealed on January 1, 1973.

General reasons for change.—The Congress concluded that it was inappropriate to reduce these excise taxes during a period of budgetary deficits and continuing inflationary pressures when the Federal Government was applying other forms of fiscal and monetary restraints to control the inflationary pressures.

Explanation of provision.—The scheduled reduction in the excise taxes on passenger automobiles and communications services was postponed for one year. Accordingly, the Act provides that the rates effective in 1969 are to continue through 1970, and each subsequent scheduled reduction postponed for one year.

Revenue effect.—The extension of the excise taxes on communications services and automobiles provided by the Act is estimated to increase revenues by \$0.5 billion in fiscal year 1970 and \$1.1 billion in fiscal year 1971.

W. REPEAL OF THE INVESTMENT CREDIT

(Sec. 703 of the Act and secs. 46, 47, and 49 of the code)

Prior law.—Prior law provided a 7-percent tax credit (3 percent for public utility property) with respect to qualified investment. In general terms, the investment credit was available with respect to: (1) tangible personal property; (2) other tangible property (not including buildings and structural components) which was an integral part of manufacturing, production, etc., or which constituted a research or storage facility; and (3) elevators and escalators. In addition, the property had to be depreciable property with a useful life of 4 years or more. New property fully qualified for the credit, but in the case of used property only an amount up to \$50,000 could be taken into account in any year. Property with a useful life of from 4 to 6 years qualified for the credit to the extent of one-third of its cost. For property with a useful life of 6 to 8 years, qualification was with respect to two-thirds of the investment, and for property with an estimated useful life of 8 years or more, the full amount qualified.

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

General reasons for change.—After careful consideration of the sources of the current inflationary pressures, the Congress concluded that the stimulus to investment provided by the credit contributed directly to these pressures. In addition to its effect on inflationary pressures, it concluded that the 1969 level of investment could not be maintained for more than a short period of time, and that it was important for the long-run vitality of the economy to keep the level of investment on a steady growth path.

Continued availability of the investment credit during an inflationary period was objected to on the grounds that it served to offset the effect of anti-inflationary fiscal and monetary policies. While tight money and higher taxes generally serve to discourage investment during an inflationary period, the investment credit significantly reduced their effects. Tight monetary policy was partially neutralized because the investment credit increased the supply of internal funds and reduced a firm's need to enter the money market to finance new investment. Higher taxes tended to reduce the internal supply of funds, but the investment credit tended to restore this supply. As a result, business firms could finance their investment plans, to get ahead of anticipated higher prices in the future, while their additions to otherwise normal current investment demand contributed to even higher prices. This investment would not increase the long-run growth of productive capacity because the investment, for the most part, would have been made anyway, although at a later date, but it would tend to reduce post-inflation investment. Inflation-motivated investment also tended to drive up the cost of plants and equipment, thus contributing to a cost structure of the economy which could be permanently higher than it would have been had the investment taken place more gradually.

In view of the factors outlined above, the Congress concluded that it had the choice of suspending the investment credit, which is what Congress did in 1966, or repealing the credit. A review of the experience during the suspension period revealed that suspension became a positive deterrent to investment as the end of the period was approached. Businessmen realized that by postponing their investments a few months these investments would again be eligible for the credit. The Congress concluded that it was undesirable to repeat that experience and, as a result, decided that the repeal of the credit was the realistic choice.

Because of the double economic effect of suspension of the investment credit and because of the administrative problems involved in turning the investment credit off and on, the Congress concluded that it was better to repeal the investment credit than to suspend it. Moreover, it believed that even though an investment credit may have been useful in the past in inducing investments in periods when there was a large deficiency of investment, it was not clear that the same type of problem

would be faced in the future. For this reason also, the Congress concluded that it was better to repeal the credit, rather than suspend it. It noted that if the need should, in the future, arise for a further stimulant to investment, the Congress would then be free to consider various alternative types of treatment. Moreover, it was not clear, once the appropriate rate of investment had been restored, whether in the future special inducements to investment would again become necessary. It might be that the normal incentives of potentially greater profits in the context of a stable growth, full employment economy would provide the investment needed without resort to special devices to stimulate investments which, on occasion, appear to give rise to investment booms.

Explanation of provision.—The Act makes the following changes with regard to the investment credit:

(i) *Repeal of investment credit.*—The Act provides that the investment credit is not to be available with respect to property on which physical construction, reconstruction, or erection began after April 18, 1969, or which was acquired by the taxpayer after that date. As a result, the investment credit generally is not available for property acquired after April 18, 1969, by a taxpayer even though the construction of the property (by someone other than the taxpayer) began before that date. The Act provides certain exceptions to this general rule as to the availability of the investment credit in the case of property constructed (reconstructed or erected) or acquired under a binding contract entered into before April 19, 1969, or in other transitional situations which are discussed below. The binding contract rule and other transition rules provided are in general the same as the rules provided by Congress in 1966 in connection with the suspension of the investment credit.

The construction of property is considered as begun when work of a significant nature has started with respect to the property. This means that if the foundation or installation is significant and has been started, the construction of the property is considered to have begun. Also, if manufacturing of important parts of the property has begun, construction is considered as commenced. Similarly, if assembly of parts (other than for inventory) has started, this too indicates the beginning of the construction of the property. However, construction of a facility or equipment is not considered as begun if work has started only on minor parts or components of it. For example, the construction of a transistor to be used in a computer does not mean the beginning of the construction of the computer.

To overcome difficulties which a number of companies might otherwise have had in identifying, under their accounting systems, whether a particular item placed in service was acquired on or before April 18, 1969, or pursuant to contracts that were binding on that date, a first-in-first-out rule is to be followed. The problem arises where the companies regularly acquire (or manufacture themselves) and maintain a large stock of identical or similar pieces of property to be placed in service as needed. The accounting systems may not identify, with respect to each item, the date it was acquired or constructed (or the date the contract for its acquisition was entered into). In these situations, the companies are to assume that the first items put in service after April 18, 1969, were those they had on hand or which were under a binding contract on that date.

(i) *Availability of credit.*—The investment credit is available at the time the property is placed in service or, in other words, when the depreciation with respect to the property begins. To insure that taxpayers will receive for a reasonable period of time the credit they had contemplated when they became substantially committed to the acquisition of property, the Act provides that where these commitments have been made the 7-percent investment credit continues to be available for property placed in service through the end of 1975. Thus, where property qualifies for the credit because of the binding contract or other transition rules, a full credit will be available for the property if it is placed in service prior to January 1, 1976. No credit will be available for property placed in service after 1975.

(ii) *Carryovers of unused investment credits.*—At the end of 1968, taxpayers had approximately \$2 billion of unused investment credits. If these unused credits were allowed to be carried over and used without limitation (other than the general 50 percent of tax liability limitation), much of the revenue gain and economic restraint which could otherwise be expected in the fiscal year 1970 arising from the repeal of the investment credit would be eliminated. To avoid this effect, the Act provides a limit on the amount of unused credits which may be carried over to 1969 and each subsequent year.

Generally, this limitation restricts the amount of unused credits which a taxpayer can claim as carryovers in any year after 1968 to 20 percent of the aggregate amount of unused credits otherwise available as a carryover to the year in question.

An additional 3-year carryforward period is made available for unused investment credits which may not be used as a carryover in a taxable year solely because of the new 20-percent limitation. This additional carryforward is designed to minimize the possibility that the limitation may operate to completely deny taxpayers the benefit of investment credits which they have already earned. This could have occurred where the special limitation prevented the use of an unused credit carryover and the regular 7-year carryforward period had expired.

The amount of unused credits which a taxpayer can claim as carryovers to any year beginning after 1968 is subject to a special limitation. The special limitation provides that the credit taken, attributable to the carryovers, cannot exceed 20 percent of the aggregate amount of the taxpayer's unused investment credits which otherwise would have been available as carryovers to the year in question after 1968, or any prior year after 1968 if the carryovers to that year are higher than in the current year (the aggregate carryovers are computed by taking into account carryforwards from prior years and carrybacks from subsequent years; carrybacks from subsequent years retroactively increase the limitation). This limitation on the amount of unused credits which may be used as carryovers in a year applies in 1969 and in each subsequent taxable year.

The special limitation provided by the bill on the use of carryovers is in addition to the general 50 percent of tax liability limitation on the amount of investment credit which a taxpayer may claim in a year. The rules under prior law regarding the order in which unused credit carryovers to the current year from two or more other years are to be used in the current year (the unused credits of the earliest year in-

volved are used first, then the unused credits from the next earliest year are used, etc.) continue to apply.

The Act also provides that unused investment credits which may not be used as a carryover in a taxable year solely because of the 20-percent limitation may be carried over for an additional 3 years. In other words, to the extent an unused credit could have been carried over to a year and used in that year under the general 50-percent of tax liability limitation but because of the 20-percent limitation cannot be so used, an additional 3-year carryover period be available. The use of the carryovers during the additional 3-year period are subject to the general 50 percent of tax liability limitation and the 20-percent limitation in those subsequent years.

The operation of the limitation may be illustrated by the following example. Assume a calendar year taxpayer has \$500 of unused investment credits from years prior to 1969 which otherwise would be available as carryovers to 1969. Under the limitation, a \$100 limit (20 percent of \$500) is placed on the amount of carryovers which the taxpayer could use in 1969 and in each subsequent year. If in this case the \$500 of unused credits were composed of \$150 of unused credits arising from the year 1962 and \$350 of unused credit arising from the year 1968, and, in the absence of the special 20-percent limitation (i.e., under the general 50 percent of tax liability limitation), the taxpayer could have claimed \$125 of the carryovers in 1969, then an additional 3-year carryover period is provided for \$25 of the \$50 of the carryover from 1962 which could not be used in 1969. This is the amount of the carryover from 1962 which could have been used in 1969 under the general limitation but cannot be used because of the special 20-percent limitation. Since the other \$25 of the carryover from 1962 could not have been used in 1969 under the general 50-percent limitation, no additional carryover period is provided for this amount.

If the taxpayer in this example should place property in service in 1972 which is eligible for the investment credit (for example, because of the binding contract rule or another transition rule) and as a result of the 50 percent of tax liability limitation in 1972 there should be an unused investment credit in that year, the fact that the unused credit would otherwise be available as a carryback to 1969 operates to increase retroactively the limitation on the use of carryovers in 1969. For example, if the unused credit arising from the investment in 1972 were \$300, this would have the effect of increasing the amount of unused credits which otherwise could be carried over to 1969 to \$800 (the \$500 of carryforwards from years prior to 1969 and the \$300 carryback from 1972. Accordingly, the limit on the use of carryovers in 1969 would be increased retroactively to \$160 (20 percent of \$800). Under the basic rule that the carryovers to a year which are actually used in that year are considered to be the unused credits arising from the earliest year involved, the retroactive increase of the carryover limitation from 1969 to \$160 means that all of the taxpayer's \$150 of unused credits arising from the year 1962 would then become usable under the special limitation as a carryover in 1969 (however only \$125 would be allowable in 1969 under the 50-percent limitation).

In this example the new \$160 limitation on the use of unused credit carryovers continues to apply in each of the years after 1969 unless the aggregate amount of unused credits otherwise available as carryovers to one of those years (taking into account both carryforwards of re-

maining unused credits and carrybacks of unused credits arising from subsequent investments under the binding contract rule or another transition rule) exceeded \$800 (the carryover amount used in determining the \$160 limitation). In such a case, a new limitation based on the higher amount of carryovers would be determined which then would be applicable in that year and in subsequent years.

(iv) *Binding contracts.*—The investment credit is available with respect to property which is constructed (reconstructed or erected) or acquired pursuant to a contract that was binding on the taxpayer at the close of April 18, 1969, and at all times thereafter. This provision applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract, and does not apply to a contract with a person other than the builder or supplier under which the taxpayer becomes obligated to construct, reconstruct, erect, or acquire property. A supplier for this purpose need not be the person who manufactures the property which is being acquired, but may be a distributor or other type of middleman. (To the extent so-called third party leases and contracts are intended to be covered, see subsequent discussion.) Thus, a contract with a financial institution, a bond underwriter, or a labor union under which the taxpayer is obligated to acquire property is not covered by this provision.

Whether or not an arrangement between a taxpayer and a builder or supplier constitutes a contract is to be determined under the applicable local law. A contract for this purpose may be oral or written. However, in the case of an oral contract, the taxpayer must establish by appropriate evidence that the contract was, in fact, entered into before the close of April 18, 1969. This may be done by memorandums, the conduct of the parties or other evidence that a contract was in fact entered into. State law as to the effect of "part performance" and as to when a seller has accepted an order apply.

A binding contract for purposes of this provision exists only with respect to the property which the taxpayer is obligated to accept under the contract. Thus, when prior to April 19, 1969, a taxpayer had contracted to purchase a lathe but not the motor to run the lathe, the investment credit is denied under this rule only with respect to the motor (but see special 50-percent rule for machinery and equipment set forth below). In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items he must purchase. Similarly, where the taxpayer is bound under a contract to purchase either of two or more specified items, this rule applies only to the extent of the contract price of the least costly of the items which may be selected.

A contract may be considered binding on a taxpayer even though (a) the price of the item to be acquired under the contract is to be determined at a later date, (b) the contract contains conditions whose occurrences are under the control of a person not a party to the contract, or (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract. These rules may be illustrated by the examples which follow.

A contract to buy a specified type, grade, and amount of steel, the price to be the market price on the day of delivery, may be a binding contract. A contract which is conditioned upon obtaining a certifi-

cate of convenience and necessity from a public utilities commission may be a binding contract. Where, under a contract to purchase a machine tool, the purchaser has the right to modify the specifications for the tool to reflect current technological advances, the contract may be a binding contract. Similarly, where a contract contains a condition which is under the control of one of the parties to the contract and this party is obligated (either by the specific terms of the contract itself or by operation of State law) to use his best effort to secure the occurrence of the condition, the existence of the condition in the contract does not prevent the contract from being one which is binding on the taxpayer. For example, if a contract to purchase equipment is conditioned upon the supplier being able to supply the equipment within a specified period of time and the supplier is obligated to use his best efforts to satisfy this condition, the contract may be a binding contract.

On the other hand a contract which is binding on a taxpayer on April 18 will not be considered binding at all times thereafter if it is substantially modified after that date. A waiver of a right to cancel upon a price change is an example of a substantial modification.

A contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this provision unless the amount paid for the option is forfeitable (if the taxpayer does not exercise his option), is to be applied against the purchase price of the property (if the taxpayer exercises his option) and then only if the amount paid for the option is not nominal. Similarly, a contract which limits the damages to be recovered, in the event of a breach by the purchaser, to the amount of a deposit or to liquidated damages is not a binding contract if the deposit or the liquidated damages are nominal in amount. In determining whether a deposit, or liquidated damages, or the amount paid for an option is nominal, the size of the deposit, etc., relative to the contract price of the property which is the subject matter of the contract is to be taken into account. If the deposits, etc., are a significant portion of the price of the item, the contract may be a binding contract. For example, a deposit of \$50,000 in connection with a contract to acquire property at a price of \$1 million is a significant portion of the contract price.

Where an order for the purchase of property may be canceled by the purchaser within a specified period of time, such as 90 days, the order is a contract binding on the purchaser if the period of time had expired before April 19, 1969, or the right to cancel the contract had been terminated before that date by partial performance with the buyer's consent. Similarly, the right of a buyer under a contract for the acquisition of property to cancel the contract if the seller raises the selling price, a so-called price escalation clause, does not prevent the contract from being binding on the buyer until the buyer becomes entitled to exercise his cancellation rights.

If a taxpayer who had entered into a contract for the construction of property prior to April 19, 1969, completes the contract himself because of the default of the other contracting party, the taxpayer is considered to have a binding contract to the extent that he was bound on the contract prior to the default.

There is not a binding contract if the property to be supplied is not specifically identified and determined before April 19, 1969. Thus, for example, if a financier has agreed with an airline to buy

planes and lease them to the airline when requested (whether or not some maximum is provided), there is no binding contract as to those planes which were not requested before April 19. However, this is not intended to foreclose the allowance of the investment credit in the case of a contract to lease, which in all respects was binding on the lessor on or before April 18, 1969, where the lessee was not required to take a specified amount of the property in question if the lessor retained the investment credit with respect to the property. In this case, the party having the investment credit has a binding contract.

(v) *Equipped building rule.*—Once construction on a building has begun there are likely to be commitments which make it necessary to complete the building as well as to acquire machinery and equipment¹ and appurtenances necessary to the operation of the building. Therefore, the Act contains a rule which, in general, provides that where construction of a building has begun before April 19, 1969, and the cost of the building plus any machinery and equipment for it which has been ordered (under a binding contract) or constructed before April 19, 1969, represents more than half of the entire cost of the building and planned equipment, the entire equipped building project and incidental appurtenances are eligible for the investment credit to the extent they would otherwise qualify for the credit. Where the costs incurred before April 19, 1969, do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately (as provided in prior law) for purposes of determining whether the item qualifies for the investment credit.

There are various types of commitments which are made before physical construction has commenced or a binding contract has been entered into which, although they occurred before April 19, 1969, do not result in the allowance of the investment credit. In part, these were not taken into account because their varied nature makes it impossible to specify with certainty in the statute those cases where the investment credit would be available and those cases where it would not.

The equipped building rule specifies that the investment credit is to be available with respect to the equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(a) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific plan of a taxpayer in existence on April 18, 1969; and

(b) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the plan) was attributable to property on which either construction was begun or which was acquired or under binding order before April 19, 1969.

In applying this 50-percent test, the machinery or equipment ordered or constructed before that date which is taken into account includes the cost of essential parts or components ordered subsequently which, under the special machinery and equipment rule (explained below), is to be eligible for the investment credit. This rule, of course, does not allow the taxpayer to add machinery and equipment with respect to a building under construction at will, since the building and equip-

¹ The term "machinery and equipment" is generally used here to denote property which is of a type that is eligible for the investment credit.

ment must be a part of a specific plan of the taxpayer in existence before April 19, 1969. While this plan may be modified to a minor extent after that date (and the property involved still come under this rule), nevertheless, there cannot be substantial modification in the plan if this equipped building rule is to apply. The plan referred to here must be a definite and specific plan of the taxpayer which, in one form or another, is available as evidence of the taxpayer's intentions.

The equipped building rule can be illustrated by an example where the taxpayer has a plan providing for the construction of a \$100,000 building with \$80,000 of machinery and equipment to be placed in the building and used for a specified manufacturing process. In addition, there may be other structures or equipment, here called appurtenances, which are incidental to the operations carried on in the building which are not themselves located in the building. Assume that the incidental appurtenances have further cost of \$30,000. These appurtenances might include, for example, an adjacent railroad siding, a dynamo or water tower used in connection with the manufacturing process, or other incidental structures or machinery and equipment necessary to the planned use of the building. Of course, appurtenances, as used here, do not include a plant needed to supply materials to be processed or used in the building under construction. In this case, if construction on the building had begun but no equipment had been ordered, and the appurtenances had not been constructed or placed under binding order, nevertheless, the entire equipped building and appurtenances, to the extent property of a type qualifying for the investment credit was involved, would be eligible for the investment credit. This can be seen by the following analysis of this example: the cost of the equipped building in this case is \$180,000 and since construction on the building had commenced, the machinery and equipment, even though not under binding order, is eligible for the investment credit as a result of this rule. This is true because the building cost represents more than 50 percent of the total \$180,000. In this connection, it should be noted that the additional cost of appurtenances, \$30,000, is not taken into account for purposes of determining whether the percentage requirement is met. However, the investment credit is available with respect to these appurtenances since the 50-percent test is met as to the equipped building.

Although the above example is one in which the construction of the building had commenced while the machinery and equipment had not been ordered, in other cases the reverse may be true. If the machinery and equipment contracted for is the major portion of the total cost in such a case, the investment credit is available with respect to the entire equipped building (to the extent eligible for the investment credit) even though the construction of the building itself has not commenced.

(vi) *Plant facility rule.*—The Act also includes a plant facility rule which is comparable to the equipped building rule (explained in (v) above) to provide for cases where the facility is not housed in a building.

Under modern practices many production facilities, which in the past were housed in buildings, are erected out in the open. This has been made possible by improved technology and is desirable in many of these cases for reasons of safety and economy. The plant facility provision provides, in effect, two rules. The first of these rules is

applicable where construction of the facility at the site had not commenced on April 18, 1969. The second rule covers the situation where such construction had commenced.

Under the first rule, if a taxpayer, pursuant to a plan in existence on April 18, 1969, constructed, reconstructed, or erected a plant facility (or portion thereof) and more than 50 percent of the aggregate adjusted basis of the depreciable property which makes up the facility is attributable to either (1) property whose construction, reconstruction, or erection was begun by the taxpayer before April 19, 1969, or (2) property whose acquisition by the taxpayer occurred before that date, then all property of the type which is generally eligible for the investment credit which makes up the facility continues to be eligible for the credit. This rule only applies if the plan under which the facility is constructed, etc., is not substantially modified after April 18, 1969, and before the facility is placed in service.

In determining whether the 50-percent requirement of this rule is met, installation costs and engineering costs which are capitalized and have been incurred prior to April 19, 1969, are taken into account. In addition, such costs which had not been incurred prior to that date but which are attributable to property whose construction, etc., had begun prior to April 19, or property which had been acquired prior to April 19, are taken into account for this purpose.

As in the case of the equipped building rule, property on order under a binding contract in effect on April 18, 1969 (and thereafter), is included in determining whether the facility meets the 50-percent requirement. The rules dealing with binding contracts (explained in *iv* above) are applicable to this provision. Similarly, property which qualifies under the special machinery and equipment rule (explained in *vii* below) is included in determining whether the facility meets the 50-percent requirement.

This provision defines a plant facility as a facility which meets the following requirements. The facility must not include a building, other than buildings which constitute an insignificant portion of the facility. In addition, it must be (1) a self-contained, single operating unit or processing operation, (2) located on a single site, and (3) identified on April 18, 1969, in the purchasing and internal financial plans of the taxpayer as a single unitary project.

The fact that the facility does not produce a commercially marketable product is irrelevant in determining whether or not a particular facility is a plant facility for purposes of this provision. Furthermore, the fact that a single operating unit or processing operation is connected, by pipes, conveyor belts, etc., to one or more other units or processing operations in an integrated processing or manufacturing system does not cause the whole system to be a plant facility. Examples of self-contained, single-operating units or processing operations which may constitute a plant facility under this rule are a railroad switching yard, a railroad bypass route, a pipeline route or right-of-way, and an ethanalamines unit.

The second rule of the plant facility provision relates to the construction, reconstruction, or erection of a plant facility which was commenced before April 19, 1969. Under this rule, if pursuant to a plan of a taxpayer in existence on April 18, 1969, the taxpayer constructed, reconstructed, or erected a plant facility, and the construction, etc., was commenced before April 19, 1969, then all property

of the type which is generally eligible for the investment credit which makes up the facility continues to be eligible for the credit. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and, therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

The plant facility provision contains a special rule applicable where a certificate of convenience and necessity has been issued to a taxpayer before April 19, 1969, by a Federal regulatory agency. The special rule applies where the certificate is applicable to two or more plant facilities which are included under a single plan of the taxpayer to construct, reconstruct, erect or acquire the plant facilities and more than 50 percent of the aggregate basis of all of the depreciable property making up the facilities is attributable either (i) to property on which the construction, reconstruction, erection was begun before April 19, 1969, or (ii) property that was acquired before that date. In such a case, the plant facilities are treated as a single plant facility and will not be subject to the repeal of the investment credit.

(vii) *Machinery and equipment rule.*—The general rule as to what constitutes construction (reconstruction or erection) of machinery and equipment has been discussed above (see (i) above). Similarly, where binding contracts have been entered into before April 19, 1969, the rules for machinery and equipment generally applicable have also been discussed (see (iv) above). In general, these rules provide that the construction begins when the production or assembly commences. In addition, the investment credit is also available with respect to machinery and equipment covered by a binding contract entered into before April 19, 1969. Under these rules, however, only the specific equipment and machinery commenced or ordered under a binding contract are eligible for the investment credit.

A specific rule also deals with machinery and equipment which was only partially on order, or under construction, on April 18, 1969. Under this rule the investment credit continues to be available with respect to any machinery or equipment for which more than 50 percent of the parts or components were on hand on April 18, 1969, or are acquired pursuant to a binding contract which was in effect on that date.

The parts and components which are on hand or on order (under a binding contract) on April 18 must be held, or have been ordered, for use in the machinery or equipment. This 50-percent requirement is determined on the basis of cost, and for the rule to apply, the cost of the parts and components must not be an insignificant portion of the total cost of the item of machinery or equipment.

Thus, for example, if there were a binding order on April 18, 1969, for the acquisition of the frame of an airplane, parts and components necessary for the airplane to become a functioning unit would also be

eligible for the investment credit (even though not on order at that time) if these remaining parts and components did not account for 50-percent or more of the total cost of all the parts and components of the airplane. Accordingly, if the motors, galley, seats, navigation, and radio equipment and necessary spare parts acquired at the time the plane is put into operation had not been ordered before April 19, but constituted less than 50-percent of the total cost of the plane, the investment credit is available not only with respect to the airframe but also with respect to this machinery and equipment as well.

This special rule is applicable to machinery and equipment wholly apart from any application the equipped building rule or the plant facility rule (explained above) may have because of the interrelationship of the machinery and equipment with a building and plant facility. However, a piece of machinery or equipment which continues to receive the investment credit under this rule is included in determining whether the equipped building or plant facility, of which it is a part, meets the 50-percent requirement of the equipped building or plant facility provisions.

(viii) *Certain leaseback transactions.*—It is common practice for a business to enter into binding contracts for the purchase of machinery and equipment used in its trade or business where the machinery and equipment is sold to a third person but leased back by the person initially ordering the property. In such cases the person entering into the purchase contract initially is committed to purchase the article. For that reason, where binding contracts have been entered into on or before April 18, 1969, and the property involved is transferred to a third party, the property is eligible for the investment credit, despite the repeal provided by the Act, if certain conditions are met.

The leaseback rule is extended to situations where the property which is sold and leased back is eligible for the investment credit in the seller's hands under the machinery and equipment rule. The provision also permits property to be leased back by a corporation which is a member of the same affiliated group as the person who transfers the property to the lessor in certain situations.

The Act provides that when a person who is a party to a binding contract transfers his rights in the contract (or the property covered by the contract) to another person and a party to the contract retains a right to use the property under a lease, then to the extent of the transferred rights, this other person is to succeed to the position of the transferor with respect to the binding contract and the property. For purposes of applying this rule, a person who holds property for which a credit continues to be available by reason of the machinery and equipment rule is treated as having had a pre-April 18, 1969, binding contract for the property. Thus, this type of property also may be transferred to another person who will succeed to the position of the transferor with respect to the property, if the transferor retains a right to use the property under a lease.

In determining whether a party to the contract retains a right to use the property under a lease (either where the property was subject to a pre-April 19, 1969, binding contract or where the property qualifies under the machinery and equipment rule), the Act provides that a corporation which is a member of the same affiliated group as the person transferring the property is to be treated as the transferor and as a party to the contract if simultaneously with the transfer of the prop-

erty to another person the corporation acquires a right to use the property under a lease with the other person.

The lease may be for any term unless the lessor decides not to exercise his statutory election to permit the lessee to claim the investment credit, in which case the lease must be for a term of at least 1 year. The purpose of the rule is to insure that the lessee, in effect, receives the benefit of the investment credit by preventing the lessor from unilaterally taking the property back and leasing to another person at a higher rental. This purpose is adequately served where the lease is for a long term, since in this case the lessor may not unilaterally take the property back prior to the expiration of the lease. Accordingly, the application of the recapture rule is restricted to situations which do not involve a long-term lease. In other words, the recapture rule continues to apply where the lessor does not elect to pass the credit through to the lessee and the lease is not for a long term but is not to apply if a long-term lease is involved. A lease is to be considered a long-term lease either if it is for a term which is substantial in relation to the estimated useful life of the leased property or if it is for a term of 8 years or more.

For purposes of applying the recapture rule in situations which do not involve a long-term lease, a lessee is not treated as losing his right to use the property if he transferred the lease in a transfer of the type which is to be disregarded in determining whether the investment credit is available (see (x) below), such as a transfer by reason of death, so long as the person to whom the lease is transferred retains the right to use the property. A lessee also is not treated as losing his right to use the property where he subleases the property unless the sublease is in effect a sham transaction. In other words, if the lessee normally would have returned the property to the lessor and the lessor then would have leased the property to another person, but instead the lessor and lessee, in effect, arrange to accomplish the same results by means of a sublease, the subleasing is treated as a disposition of the property by the lessor.

The provision described above is not applicable where the election was made and the credit passed on to the lessee, because in those cases the recapture provisions automatically come into play if the lessee's right to use the leased property terminates before the expiration of the period on which the investment credit originally is based. The rule provided in this provision also covers the case where a person obligated under a pre-April 19 binding contract is only one of two or more joint lessees under the leaseback arrangement.

The types of arrangements which are covered by this provision include:

(a) cases where the user of the machinery and equipment has a binding contract to purchase machinery and equipment on April 18, 1969, and subsequently transfers the contract to purchase the property to a third party from whom the user leases back the right to use the property;

(b) cases where, under a contract binding on April 18, 1969, to purchase machinery and equipment, a business obtains delivery of the property, immediately transfers the property (before using it) to a third party, and leases the property back;

(c) cases where a builder of equipment transfers equipment (before using it) which qualifies for the credit under the ma-

chinery and equipment rule to a third party and, simultaneously with the transfer, a corporation which is affiliated with the builder leases the property from the third person;

(d) cases where a builder or supplier of machinery and equipment entered into a lease arrangement with a business before April 19, 1969, and subsequent to that time sells the property involved to a third person subject to the lease arrangement referred to.

In the first three illustrations above, the investment credit is available because the third party (by succeeding to the position of the user, the business, and the builder, respectively) is treated as having acquired property pursuant to a contract which was binding on him as of April 18, 1969. (See (iv) above.) In the fourth illustration, the credit is available because the third person (by succeeding to the position of the builder or supplier) is treated as having constructed the property pursuant to a binding contract to lease in effect on April 18, 1969. Under the exception for property constructed pursuant to certain leases (discussed in (ix) below), property so constructed is eligible for the investment credit.

(ix) *Certain leases involving third parties.*—Certain situations are provided for where binding contracts or leases have been entered into between parties prior to April 19, 1969, which require the construction or acquisition of machinery and equipment under the terms of the lease or contract arrangements, even though the situations do not involve a binding contract of the type described earlier between the person who will use the property and the person who will construct or supply it.

Where a binding lease or contract is in effect on April 18, 1969, under which the lessor or lessee (or both) is obligated to construct (reconstruct or erect) or acquire machinery and equipment which is specified in the lease or contract, then the investment credit continues to be available with respect to any property constructed under the lease or contract. This rule is applicable where the property is specified in documents related to the lease contract or contract to lease, if the documents were filed with a Federal regulatory agency before April 19, 1969, or where the specifications of the property are readily ascertainable from the terms of the lease or contract to lease, or from the related document. In cases where a project includes property in addition to that covered by a specific lease arrangement, this provision applies to the other property only if binding leases and contracts in effect on April 18, 1969, covered real property representing at least a quarter of the entire project. (This is determined on the basis of the rental value of the different parts of the project.) This limitation is designed to prevent a large project from being covered merely because of minor or incidental lease agreements in effect on April 18, 1969. As indicated previously, this provision applies to sales contracts as well as lease contracts.

The types of cases covered by this provision include, for example, a situation where a builder of a shopping center may have entered into a lease agreement with a tenant for a major store building in a shopping center before April 19, 1969, and in connection with this lease agreement the builder agrees to build a specified number of shopping center units. In exchange for this agreement, the major store tenant agrees to equip and operate the store to be leased to him. In other cases, parties may have agreed to construct and lease industrial plants to

businesses and in exchange the businesses agree to equip the plants with machinery and equipment necessary for the businesses, either directly or under a sale and leaseback arrangement.

Where a company enters into a long-term lease with an industrial development board to lease a plant whose construction and equipping is financed through the sale of industrial development bonds, the transaction may not be considered for some tax purposes as a lease, but instead may be considered for depreciation and investment credit purposes as a financing transaction in which the company is treated as the owner. Nevertheless, it is intended under the investment credit termination rules that the transaction be treated as a lease and that such property be treated as pre-termination property in the hands of the lessee owner.

Where the Act provides that the property to be provided must be specified in the lease or contract, this is not intended to preclude the property being specified in a separate document of which both parties were fully aware at the time of the lease or contract agreement. Nor is it required that all of the property be specified in detail at that time so long as the general types and amount of property are fairly determinable at the time the lease or contract is entered into.

The rules set forth above are also modified in the case of a binding contract or contracts entered into before April 19, 1969, involving the construction, etc., or acquisition of property specified in an order of a Federal regulatory agency for which an application was filed before April 19, 1969. In such a case, if the property is to be used to transport one or more products to be purchased or sold under the contract or contracts, the investment credit continues to be available for the property if one or more parties to the contract or contracts have contractual commitments in existence on April 18, 1969, which in the aggregate require the taking or providing of more than 50 percent of the products to be transported over a substantial portion of the expected useful life of the property.

An example of the type of case covered by this provision would be a situation where a company has entered into a binding contract to buy or sell fuel and is required to construct a new pipeline or add capacity through an existing pipeline in order to transport such fuel. The provision would be applicable in this situation, however, only if one of the parties to the purchase or sale contract or contracts has contractual commitments in existence on April 18, 1969, which in the aggregate require such person to take or provide more than 50 percent of the fuel to be transported through such pipeline over a substantial portion of the useful life of the new construction, and if the new construction is specified in an order of a Federal regulatory agency for which application was made before April 19, 1969.

There also is a provision dealing with a similar type of situation that is in large part identical to a transition rule approved by Congress in 1966 in connection with the suspension of the investment credit. This provision covers situations where a taxpayer must construct (or reconstruct or erect) or acquire property to carry out a pre-April 19, 1969, binding contract and either the property is specified in the contract or it is a contract for the extraction of minerals and a number of prescribed conditions are satisfied. In these cases, the investment credit continues to be available for the property if it is to be used

to produce one or more products under the contract and if the other party to the contract is required to take substantially all the products to be produced from the property for a substantial portion of its estimated useful life (or is a State or political subdivision which is required to make substantial expenditures which benefit the taxpayer).

As indicated, this provision may be applicable in the case of a contract for the extraction of minerals even though the property is not actually specified in the contract if a series of conditions are satisfied. The mineral properties from which the minerals are to be extracted must be specified in the binding contract and the specifications for the property which the taxpayer needs to perform the contract must be readily ascertainable from the location and characteristics of these mineral properties. Moreover, the property must be original, not replacement, property and must be necessary for, and used solely in, the extraction of minerals under the binding contract. It also is required that the binding contract must be a fixed price contract (although it may provide for price changes except with respect to the loss of the investment credit). In order for property to qualify under this provision, the taxpayer must have begun construction of it, or acquired it, prior to April 19, 1970 (or pursuant to a pre-April 19, 1970, binding contract), and the property must be placed in service prior to 1973.

An example of the type of case covered by this provision would be a situation where a person is obligated under the terms of the contract to build an industrial gas plant which is specified in the contract for the purpose of supplying the industrial gas to a steel or chemical company. Another example of a type of case covered by this provision would be a situation where a coal company must acquire equipment (including items such as a bulldozer which removes overburden) in order to carry out a binding contract under which the company is obligated to open new coal mines on specified mineral properties and to sell the coal to utilities at prices fixed in the contract.

(x) *Rules where property is transferred at death, etc.*—In determining whether property is to be treated as if acquired or under binding contract before April 19, 1969 (and therefore is eligible for the investment credit), certain transfers are to be disregarded. These are cases where it seems appropriate for the transferee “to step into the shoes” of the transferor.

The first transfer where the transferee is treated the same as the transferor is a transfer by reason of death. Under this provision, property (or a contract to purchase property) with respect to which the investment credit would be available in the hands of the decedent continues to be eligible for the investment credit in the hands of the person who acquires the property from the decedent.

The same treatment is also applied to certain specified transfers in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor. The specified transfers are—

- (a) transfers to a corporation upon the liquidation of a subsidiary (sec. 332 of the code),
- (b) transfers to a controlled corporation (sec. 351 of the code),
- (c) transfers pursuant to corporate reorganizations (sec. 361 371(a), and 374(a) of the code),

(d) transfers of property to a partnership by a partner in exchange for an interest in the partnership (sec. 721 of the code), and

(e) transfers by a partnership to a partner (sec. 731 of the code).

In addition, where under a special provision of the code (sec. 334(b)(2)) the acquisition by a corporation of the stock of another corporation and the liquidation of the acquired corporation are treated as the purchase of the assets of the liquidated corporation for purposes of computing the basis of the assets acquired, the transfer of the assets is disregarded in determining whether the credit is available if the stock of the distributing corporation was either acquired before April 19, 1969, or pursuant to a binding contract to acquire the stock which was in effect on April 18, 1969, or both.

Among the transfers to be disregarded in determining whether the credit is available is the type of transfer where substantially all of the assets of a corporation are purchased pursuant to a pre-April 19, 1969, contract which is binding on the purchaser. This eliminates the potential disparity in treatment between a direct purchase of a corporation's assets pursuant to a pre-April 19, 1969, binding contract and an indirect purchase of the corporation's assets (i.e., the acquisition of the stock of the corporation pursuant to such a binding contract and the subsequent liquidation of the corporation under sec. 334(b)(2)).

(xi) *Property acquired from affiliated corporations.*—It is a common practice in some affiliated groups of corporations for the group to do its purchasing outside the group through one of the corporations which is a member of the group. In these situations, acquisitions by, and binding contracts of, the purchasing member of the group are considered as acquisitions by, or contracts of, the corporation for which they are made, for purposes of the Act. For this reason, property acquired by a corporation which is a member of an affiliated group for another member of the same group is treated as having been acquired by the other member on the date it was acquired by the purchasing corporation, and where a binding contract for the construction, reconstruction, erection, or acquisition of property has been entered into by the one member of a group, the corporation on whose behalf the contract was made is to be treated as having entered into the contract on the date on which it was entered into by the other member. In addition, the corporation is treated as having commenced construction, and so forth, of any property on the date on which another member commenced construction, etc.

In cases where an affiliated group of corporations files a consolidated return, similar treatment is accorded to intragroup transfers of property or contracts. This treatment is consistent with that generally provided under the consolidated return regulations. Accordingly, the Congress contemplates that under the consolidated return regulations in the case of intragroup transfers of property or contract rights during a year in which consolidated returns are filed, other than section 334(b)(2) transactions, the transferee member is to stand in the shoes of the transferor member for purposes of determining whether property continues to be eligible for the investment credit.

A contract between members of an affiliated group is not treated as a binding contract, insofar as such members are concerned (for purposes of the binding contract rule, the other transition rules, and the provision disallowing the investment credit in certain situations involving leased property, see *(xiv)* below). This rule does not apply in certain cases where one or more members of an affiliated group have disaffiliated. The Congress in this exception was concerned with the type of situation where corporations which were members of the same affiliated group entered into a binding contract with each other before April 19, 1969, but by June 30, 1969, and prior to the completion of performance of the contract, the corporations no longer are members of the same affiliated group. In these cases, the contract is to be treated as a binding contract.

Generally, although a contract between members of an affiliated group may be legally binding, it is not binding as a practical matter. It is not intended that, because the Act deals expressly with contracts between two members of an affiliated group while remaining silent as to other contracts between related parties, any inference is to be made that any other contracts which are not binding because of the relationship of the parties are to be treated as binding for purposes of the Act.

(xii) Barges for ocean-going vessels.—Another type of situation covered by the Act is where property is constructed pursuant to a binding contract in effect on April 18, 1969, even though it is not a binding contract between the person who will use the property and the person who will construct it. This situation involves barges for use on ocean-going vessels in certain situations where the vessels were under a binding contract on April 18, 1969, but the barges had not been ordered by that time. In essence these are situations where the ocean-going vessel, the so-called mother ship, and the barges it is designed to carry are complementary parts of a total ship. Although the mother ship otherwise would be eligible for the investment credit (pursuant to the binding contract rule), the barges which, in effect, are an integral part of that ship would not otherwise be eligible for the credit.

The Act provides that the investment credit is to be available for barges which are specifically designed and constructed or acquired for use with ocean-going vessels which are designed to carry barges if the credit continues to be available for the vessels (pursuant to the binding contract rule or other transition rule). The number of barges to which this provision applies, however, is subject to one of two alternative limitations. The first limitation is the number of barges specified in an application for mortgage or construction loan insurance filed under title XI of the Merchant Marine Act, 1936, with the Secretary of Commerce provided the application was filed prior to April 19, 1969. Under this limitation it is only required that the prescribed application specifying the number of barges to be used in connection with the mother-ships have been filed prior to April 19, 1969. The fact that the application was approved in whole or in part before or after April 19, 1969, is not relevant in determining the number of barges which may qualify under this provision.

If the above described limitation does not apply because the specified application was not filed, then the number of barges for which an investment credit is to continue to be available is to be limited to the

number which the taxpayer establishes as necessary to the initial planned use of the mothership provided that more than 50 percent of that number of barges otherwise are eligible for the credit (under the binding contract rule or other transition rule).

The investment credit also is allowable under this provision for any machinery and equipment which is to be installed in the barges covered by the provision if the machinery and equipment is necessary for the planned use of the barges.

(*xiii*) *Certain new design products.*—Cases have arisen which involve situations where taxpayers had undertaken a project to produce products of a new design pursuant to binding contracts which had been entered into prior to April 19, 1969. In order for the party undertaking the project to continue it, it is necessary for that party to obtain or construct certain machinery and equipment. The Act provides that the investment credit is allowable with respect to the machinery and equipment (if it is placed in service before 1972) in situations of these types, if a significant portion of the project was completed or committed prior to April 19, 1969.

Specifically, the Act covers situations where a taxpayer had undertaken prior to April 19, 1969, a project to produce a product of a new design pursuant to binding contracts in effect prior to that date, if conditions set forth below are met. First, the binding contracts must be fixed price contracts. The contracts may contain provisions which require or permit price changes resulting from changes in rates of pay or cost of materials. The permitted price change provisions would include a provision under which the adjustment in the price of the product is determined with reference to relevant statistical indexes. Second, it is required that the binding contracts cover more than 50 percent of the entire production of the newly designed product to be delivered prior to 1973. Third, this provision is applicable only were prior to April 19, 1969, more than 50 percent of all depreciable property (determined on the basis of the aggregate adjusted basis of the property) required to be constructed (reconstructed or erected) or acquired to carry out the binding contracts either was under construction (reconstruction or erection) by the taxpayer, had been acquired by the taxpayer, or was under a binding contract for construction or acquisition. In applying this 50-percent test, certain productive items (jigs, dies, templates, and similar items) which are specifically designed for, and are only suitable for use in, the manufacture or assembly of the newly designed product under the project are considered as property which was under a binding contract for construction on April 18, 1969, if these items were described in written engineering and internal financial plans of the taxpayer in existence on that date. It is sufficient for this purpose that the plans of the taxpayer generally describe the productive items.

The newly designed product which is the subject of the project undertaken by the taxpayer must, in fact, be a product which is substantially changed from products previously produced by the taxpayer. In other words, a product is not considered to be of a new design if it is basically merely a new model of a product previously produced by the taxpayer. For example, a project by an airplane manufacturer to produce a new model of an existing commercial airplane produced by the taxpayer, which had only a somewhat larger

passenger carrying capacity and a moderately longer range than the existing model, is not considered a project to produce a product of a new design. On the other hand, an airplane designed for commercial use is considered a product of a new design if it had a substantially greater carrying capacity than the existing models of commercial planes produced by the taxpayer.

(xiv) *Certain leased property.*—The investment credit is not allowed in certain situations involving leased property where it is likely that the lessor has changed his usual manner of doing business primarily to obtain the benefits of an investment credit which otherwise would be disallowed.

Specifically, in the situations where—

(i) property is leased after April 18, 1969 (other than pursuant to a binding contract to lease entered into before April 19, 1969),

(ii) the property is eligible for the credit in the hands of the lessor but would not be eligible for the credit if acquired by the lessee, and

(iii) the property is of the same kind which the lessor ordinarily sold to customers before April 19, 1969, or ordinarily leased and passed the credit through to the lessee before that time,

then neither the lessor nor the lessee may receive an investment credit with respect to the property.

In these situations, if the lessor had continued his usual manner of doing business, the leased property would not have been eligible for the credit since it would have been acquired by the purchaser or the lessee after April 18, 1969. It appears, however, that the lessor by changing his method of doing business could (in the absence of this provision) obtain the benefits of a credit because the property either had been acquired by him before the repeal date or is, in effect, treated as having been so acquired under the binding contract rule or another transition rule.

(xv) *Rules relating to certain casualties and thefts and to the replacement of certain section 38 property.*—Prior law provided for the recapture of the investment credit where property with respect to which the credit was allowed was disposed of before the end of the period (that is, 4–6, 6–8, or 8 or more years) which was used in determining the amount of the credit originally allowed. Where the property disposed of was replaced by other property eligible for the investment credit, however, the effect of prior law in allowing a credit for the replacement property was to reduce or eliminate the recapture of the credit with respect to the property disposed of. In other words, the credit allowed on the replacement property offset the credit recaptured with respect to the property disposed of.

Essentially the same treatment is to continue after the repeal of the investment credit where the replacement property is similar or related in use to the property disposed of. Accordingly, where property with respect to which an investment credit was obtained is disposed of and is replaced by property that would be eligible for the investment credit if the credit had not been repealed, then, in effect the amount of the credit recaptured with respect to the property disposed of is reduced (but not below zero) by the amount of the credit which would have been allowed (in the absence of the repeal) for the replacement property. In order for this rule to apply, the replace-

ment property must be placed in service by the taxpayer within 6 months after the time the property which it replaces is disposed of.

Prior law also contained special rules with regard to the recapture of the credit where property was stolen, or damaged or destroyed by casualty (referred to here as "casualty property"). Where the casualty property was replaced by property eligible for the investment credit, these rules basically had the effect of preserving the investment credit with respect to the casualty property.

The Act continues essentially the same treatment by providing that the replacement rules described above (other than the 6-month requirement) also are to apply to casualty property where the casualty occurs before April 19, 1969. Where the casualty occurs after April 18, 1969 it is provided that the recapture rules do not apply to the casualty property.

Effective date.—The repeal of the investment credit applies with respect to property on which physical construction, reconstruction, or erection began after April 18, 1969, or which was acquired by the taxpayer after that date. The Act also provides certain exceptions to this general rule under which the investment credit is available in the case of property which is constructed (reconstructed or erected) or acquired under a binding contract entered into before April 19, 1969, and in certain other transitional situations.

Revenue effect.—Repeal of the investment credit results in an estimated revenue increase of \$1.3 billion in fiscal year 1970, \$2.5 billion in fiscal year 1971, and \$3.3 billion a year when fully effective.

X. AMORTIZATION OF POLLUTION CONTROL FACILITIES

(Sec. 704 of the Act and sec. 169 of the code)

Prior law.—Under prior law a taxpayer could claim an investment credit with respect to pollution control facilities to the extent they involved property of a type for which the investment credit generally was available.

General reasons for provision.—The Congress recognized that an important challenge facing our nation is the problem of environmental pollution. Our rivers, lakes, streams and air are becoming increasingly polluted. Moreover, this is a problem which affects both the rural sections of our country and also our urban complexes. Industrial and human wastes and sewage are increasingly contaminating our rivers and our air is being increasingly polluted by industrial and other contaminants.

Congress has addressed itself to the air and water pollution problem in legislation which it has passed in recent years. In order to deal effectively with the nation's air and water pollution problem, however, it concluded a significant part of the task must be met by private industry. In effect, private industry is being asked to make an investment which, in part, is for the benefit of the general public. It also has been estimated that existing factories which attempt to curb pollution effectively through the addition of antipollution equipment may face significant increases in capital costs. Moreover, expenditures for pollution control equipment generally do not result in any increase in the profitability of a plant.

In the past, companies which installed antipollution equipment involving property of a type for which the investment credit was available received, in effect, an incentive through this credit for dealing with the pollution problem. The repeal of the investment credit, therefore, would have an undesirable effect on the efforts made by private industry to combat pollution were not another type of incentive to be made available.

To deal with the undesired effect on pollution control of repealing the investment credit and at the same time to deal with the increasing air and water pollution problem facing the nation, the Congress concluded that it was appropriate to provide an incentive to private industry for antipollution efforts. It concluded, however, that it was more appropriate to permit the rapid recovery of the costs involved than to permit a return in excess of total costs.

The Congress concluded that it should limit the special incentive offered to those situations where the need is the greatest. Since the cost of modifying an existing plant for pollution control purposes generally is substantially in excess of the cost of incorporating pollution control facilities into a new plant, the Congress limited the scope of the 5-year amortization deduction provision to facilities added to existing plants. In addition, it provided that only the part of the cost of the facility attributable to the first 15 years of a facility's useful life may be amortized under this provision. It concluded that a 5-year writeoff in the case of long-lived assets would provide an unduly large stimulus to the purchase of these assets vis-a-vis shorter-lived assets.

The Congress noted that the incentive provided in this Act is not a complete answer to the pollution problem. It stated that a need for broader and more effective pollution control standards remains. It believed, however, that the amortization deduction provided by the Act would be a useful component of the nation's total effort to deal with the pollution problem.

Explanation of provision.—Under the Act, a taxpayer (including an estate or trust) is allowed, at his election (under regulations prescribed by the Treasury Department) to amortize a certified pollution control facility over a period of 60 months. The amortization deduction is limited to pollution control facilities added to plants (or other properties) which were in operation before January 1, 1969. Thus, the special amortization provision is not available in the case of facilities included in new plants built in the future. The 5-year amortization deduction is limited further by allowing it only for the proportion of the cost of the property attributable to the first 15 years of its normal useful life. Where a property has a normal useful life of more than 15 years, the taxpayer in effect treats his facility as if it were two separate facilities. One facility (representing the portion of the total cost attributable to the first 15 years of useful life) is eligible for the 5-year amortization. The other facility (the remaining cost) receives regular depreciation based upon the entire normal useful life of the property. If the property has a normal useful life of 15 years or less, the total cost of the property is eligible for the 5-year amortization.

The 60-month amortization period with respect to a facility begins either with the month after that in which the facility was completed or acquired, or with the next year, whichever the taxpayer elects. The amortization deduction for any month is in place of the regular depreciation deduction which would be allowable for that month (un-

der section 167) with respect to the portion of the facility eligible for amortization. A taxpayer who elected the amortization deduction with respect to a facility, however, is still eligible to receive the additional first-year depreciation allowance (provided under section 179) with respect to that facility. However, no investment credit is available for that portion of any facility with respect to which the 5-year amortization deduction had been elected.

If the assets of a corporation are acquired by another corporation in a transaction subject to section 381 (which provides for the carryover of certain items in the case of certain corporate acquisitions), the acquiring corporation is treated for purposes of this provision as if it were the acquired corporation.

The amortization deduction is available only with respect to a "certified pollution control facility," which generally is defined as depreciable property which is a separate identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat, and which is appropriately certified. A building is not a pollution control facility unless it is exclusively a treatment facility. Thus, a pollution control facility does not include any facility which serves any function other than pollution abatement. Moreover, facilities which only diffuse pollution, as distinct from abating it, are not pollution control facilities. In other words, a pollution control facility is an installation which prevents or minimizes the direct release of pollutants into the air or water in the course of manufacturing operations. For example, a smokestack on a plant whose height was increased to disperse pollutants over a broader area is not a pollution control facility while a device which is contained in a smokestack and actually abates the emission of pollutants is a pollution control facility. In addition, a facility that removes certain elements from fuel (for example, sulphur which would be released as a pollutant when the fuel is burned) is not a pollution control facility.

The amortization deduction is available only with respect to a facility whose construction (reconstruction or erection) is completed by the taxpayer after 1968, or which is acquired after 1968, if the original use of the property commences with the taxpayer after that time. Only that portion of the basis of property constructed (reconstructed or erected) by the taxpayer which is properly attributable to construction (reconstruction or erection) after 1968, is taken into account for purposes of the amortization deduction.

As indicated, the amortization deduction is available only with respect to a pollution control facility which is certified by the appropriate State and Federal authorities. In the case of water pollution, the State certifying authority means the State water pollution control agency as defined in the Federal Water Pollution Control Act, and the Federal certifying authority is the Secretary of the Interior. In the case of air pollution, the State authority is the air pollution control agency as defined in the Clean Air Act, and the Federal authority is the Secretary of Health, Education, and Welfare. An interstate agency authorized to act in place of a State certifying authority is treated as the certifying authority of the State.

Under the certification required by the Act, it is necessary with respect to any pollution control facility for the State authority to certify to the Federal authority that the facility had been constructed

(reconstructed or erected) or acquired in conformity with the State program or requirements regarding the abatement or control of water or air pollution or contamination. It is further necessary for the Federal authority to certify to the Secretary of the Treasury with respect to any pollution control facility that the facility (1) was in compliance with the applicable regulations of Federal agencies, and (2) was in furtherance of the general policies of the United States for cooperation with the States in the prevention and abatement of water or air pollution under the Federal Water Pollution Control Act or the Clean Air Act, respectively.

The Federal certifying authority is not to certify any facility to the extent it appears that the costs of the facility would be recovered over its actual useful life by reason of profits arising from the recovery of wastes or otherwise in the operation of the facility. This limitation is designed to insure that the incentive for controlling air and water pollution provided by the amortization deduction is not available in situations where it, in effect, would provide a windfall to taxpayers, i.e., where the cost of the facility is recovered through the sale of by-products derived from its operation.

With respect to property for which the amortization deduction provided by the Act has been elected, the Act further provides for the recapture (under section 1245) of the amortization deductions claimed with respect to the property. In other words, to the extent of the previous amortization deductions, a gain arising on the disposition of a pollution control facility is treated as ordinary income.

The amortization deduction may be discontinued by a taxpayer at any time. If a taxpayer does discontinue the amortization deduction, then he may depreciate the property starting with the first month to which the amortization deduction is not applicable. A taxpayer who does discontinue the amortization deduction, however, is not entitled to any further amortization deduction with respect to that facility.

Under the provisions of the Act, the amortization deduction is available only for air or water pollution control facilities placed in service before January 1, 1975. This will provide the Congress with an opportunity to evaluate the effectiveness of the program in achieving its objective.

Effective date.—This provision is applicable in taxable years ending after December 31, 1968.

Revenue effect.—The provision involves an estimated reduction of income tax liability by \$15 million in calendar year 1970, \$40 million in 1971, \$70 million in 1972, and \$120 million a year in the long run.

Y. AMORTIZATION OF CERTAIN RAILROAD ROLLING STOCK, ETC.

(Secs. 705 and 706 of the Act and secs. 184, 185 and 263(e) of the code)

Prior law.—Under prior law, a taxpayer generally could claim an investment credit with respect to railroad rolling stock. Under present depreciation guidelines, the useful life of rolling stock is 14 years.

General reasons for change.—Since the enactment of the investment credit, the railroads have been able to increase their investment in new equipment and facilities to a considerable degree. The result has been a substantial contribution to modernizing railroad equipment, increas-

ing railroad efficiency, reducing freight car shortages during seasonal periods of critical need, and improving the ability of railroads to finance acquisitions of new equipment.

Repeal of the investment credit (were it not for this provision) might affect the ability of the railroads to continue their present investment programs at the same pace. Because of the importance to the economy of a healthy railroad industry and the existence of the present shortage of freight cars, the Congress believed that an alternative form of incentive to encourage continuation of the present level of investment is needed. Moreover, it believed that it is more appropriate to permit a rapid recovery of the costs involved, rather than to permit a return of more than total costs.

Explanation of provision.—The Act adds three provisions designed to ease the impact for railroads of the problems described above. These provide a special 5-year amortization provision for rolling stock, assurance that minor rehabilitation expenses for certain railroad equipment will be deductible currently, and for the amortization of expenses incurred for railroad grading and tunnel bores.

The new 5-year amortization provision which the Act makes available applies to new rolling stock, including locomotives. (New rolling stock is rolling stock the original use of which commences with the taxpayer after 1968.) This provision applies to rolling stock placed in service after January 1, 1970. In addition, new rolling stock placed in service during 1969 is eligible for 4-year amortization to the extent of any unrecovered costs as of January 1, 1970.

The 5-year amortization provision applies only to qualified rolling stock placed in service before January 1, 1975. This will give Congress an opportunity at that time to review this amortization provision to see what, if any, changes or modifications may then appear desirable.

Under the 5-year amortization provision, it is provided that the Secretary of the Treasury (with the assistance of the Secretary of Transportation) is to issue regulations indicating particular classes of cars or locomotives which are not considered to be in short supply. Rolling stock in these specific classes of cars or locomotives which is placed in service after 1972 (or, if later, after thirty days subsequent to the final promulgation of the regulations) is not eligible for the 5-year amortization writeoff.

The 5-year (or 4-year) amortization referred to above is available with respect to the rolling stock of all domestic railroads, switching and terminal companies which are wholly owned by domestic railroads and companies (such as Trailer Train, Pacific Fruit Express and Fruit Growers Express) 95 percent or more of whose stock is owned by one or more railroads. The 5-year (but not the 4-year) amortization also is available to lessors to the extent that their rolling stock is leased to a domestic railroad or railroad company. In no event is the 5-year (or 4-year) amortization provision available in the case of rolling stock owned and used by companies other than domestic railroads or rolling stock leased to companies other than domestic railroads.

Companies eligible for the amortization deduction may elect it on a unit basis and are not required to adopt it for all rolling stock placed in service within a given year.

For purposes of the amortization provision, property placed in service by a domestic railroad or railroad company at any time during 1970 is presumed to be placed in service on December 31, 1969. Thus,

with respect to this property the amortization period commences in January 1970. In the case of rolling stock placed in service in subsequent years, the taxpayer may elect to begin the amortization period at the time when the property is considered placed in service under a consistently followed method of accounting for acquisitions and retirements of property which prescribes a date when property is placed in service.

Where a unit of rolling stock is rehabilitated (rather than repaired), the capital expenditure incurred with respect to the unit of rolling stock is to be treated as a separate unit of rolling stock for which the amortization deduction is available if such separate unit of rolling stock would otherwise qualify.

In the absence of action to the contrary, the fact that railroad rolling stock was amortized rather than subject to depreciation (with a 14-year life) would have an adverse effect on the extent to which railroads were considered as meeting the so-called reserve ratio test under the present Treasury revenue procedure setting out the "guidelines" (Rev. Proc. 62-21). To overcome this adverse effect, it is understood that the Treasury Department for 1969 and later years will take into account, for reserve ratio purposes, the acquisitions of rolling stock with respect to which the amortization election has been made. In other words, the amortization base will be considered as if it were in the appropriate depreciation schedule (in the absence of amortization) and the guideline reserve ratio test will be applied by including in the depreciation reserve a simulated amount reflecting the accumulated depreciation on such equipment as if it had been depreciated on the basis used by the taxpayer in its 1968 tax return.

To the extent the 5-year (or 4-year) amortization deductions result in larger deductions than would be available under the depreciation schedules previously in effect, the railroads are expected by the Congress to maintain a level of investment in, or maintenance of, rolling stock and other transportation equipment equal to the level of these larger deductions. Thus, the larger deductions are being allowed on the basis that they represent a larger annual level of replacement of equipment necessary in order to sustain and improve railroad service to the public. The extent to which this level is achieved and maintained will be pertinent in deciding whether this provision should be extended at its expiration date on December 31, 1974.

This does not imply that there will be any specific tracing of funds or that the amount invested in transportation equipment need necessarily represent an increase over prior transportation equipment purchases but rather that railroads should, in general, attempt to see to it that their expenditures for purchases or maintenance of rolling stock and other transportation equipment would, over a period of years, at least equal the level of deductions obtained as a result of the amortization deductions.

Rolling stock which, because of acquisition or construction before April 19, 1969 or because of the binding contract or other transition rules, is eligible for the investment credit in 1969, 1970 or later years is nevertheless to be eligible for the 5-year (or 4-year) amortization deduction writeoff. The useful life of the rolling stock for purposes of the investment credit is determined on the basis of the rolling stock's actual useful life and is not based upon the 5- (or 4-) year amortization period over which it is written off.

As indicated previously, the second change made by the Act affecting railroads is concerned with the deductibility of certain rehabilitation expenditures. In the past, upon audit by the Internal Revenue Service, questions have been raised as to the treatment of repairs in the case of railroad rolling stock. It has been contended by some agents that certain repairs of the rolling stock represent a capital improvement extending the 14-year guideline life of the rolling stock. To avoid this result in the case of railroad rolling stock other than locomotives, the Act treats the cost of rehabilitation as an expense in all cases where such costs in any 12-month period do not exceed 20 percent of the unadjusted basis of the unit involved. This is not intended as a guideline, however, with respect to the repair of any other types of transportation equipment or in the case of other transportation companies or of other equipment generally. Nor is it intended to constitute a limit on repair deductions for railroads; if amounts would otherwise be deductible as repairs, it is understood that they will continue to be deductible even though the amount exceeds this limit.

The third change which the Act makes affecting railroads permits them to amortize the adjusted basis of qualified railroad grading and tunnel bores ratably over a 50-year period. Under prior law, railroads could capitalize these costs but had not been able to depreciate them over any period because of uncertainties as to the length of their useful life.

Under the Act, the amortization deduction is to be available with respect to grading and tunnel bores the original use of which commences after December 31, 1968. The amortization deduction available is to be in lieu of any depreciation or any other amortization deduction for these gradings or tunnel bores for any year for which the election applies.

The railroad grading and tunnel bores for which this 50-year amortization deduction is available are all improvements resulting from excavations and tunneling, construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track. Expenditures for improvements of existing roadbeds or rights-of-way for railroad track are treated under this provision as costs for railroad grading or tunnel bores placed in service in the year in which the costs are incurred.

If a railroad grading or tunnel bore is retired or abandoned during a year for which this provision is in effect with respect to it, no deduction is to be allowed because of the retirement or abandonment. Instead, the amortization deduction under this provision is to continue to apply in the case of this property. An exception to this rule, however, is provided where the retirement or abandonment is attributable primarily to fire, storm, or other casualty. In such cases, the casualty loss deduction will be available in lieu of any further amortization deduction.

The amortization deduction election under this provision may be made for any year beginning after December 31, 1969. The election is to be made by filing with the Treasury Department (in the manner, form, and within the time prescribed by regulations) a statement of the election. The election, once made, remains in effect for subsequent years and applies to all qualified railroad grading and tunnel bores of the

taxpayer, unless upon application by the taxpayer, the Treasury Department permits him (subject to such conditions as the Treasury deems necessary) to revoke the election. The 50-year amortization period commences with the first taxable year for which an election is effective under this provision. For grading and tunnel bores placed in service after that time, the 50-year period for this property commences with the year following the year the property is placed in service.

Effective date.—These provisions are effective for taxable years beginning after December 31, 1969.

Revenue effect.—These provisions involve an estimated reduction of income tax liability of \$105 million in calendar year 1970, \$95 million in 1971, \$140 million in 1972, and \$85 million a year in the long run.

Z. AMORTIZATION OF CERTAIN COAL MINE SAFETY EQUIPMENT

(Sec. 707 of the Act and sec. 187 of the code)

Prior law.—The Internal Revenue Service depreciation guidelines prescribe a 10-year useful life for electrical face equipment used for safety purposes in coal mines. This is equipment which is designed to prevent machinery used in the coal mine from “sparking.” Sparking could cause ignitions and explosions if the sparking were to occur in mines where there is a sufficient concentration of methane gas. Electrical face equipment previously was not required under the Federal Coal Mine Safety Act in coal mines which are located above the water table and are classified as “nongassy” (i.e., as having a sufficiently low concentration of methane gas to be free of fire hazard or explosion in the event of a spark from electrical equipment).

General reasons for change.—Under the Federal Coal Mine Health and Safety Act of 1969, operators of nongassy coal mines are required within 6 years after the enactment of that act to modify their mining equipment by the installation of heavy duty electrical face equipment. In addition, mining machinery purchased in the future by these mine operators must have this electrical face equipment.

The upgrading or replacement of existing machinery by operators of nongassy coal mines to conform with the new Federal safety requirements could impose a substantial cost burden on many operators of nongassy coal mines. To ease this cost burden for mine operators, Congress believed that it was desirable to provide a special amortization deduction for the electrical face equipment of the type referred to above.

Explanation of provision.—Under the Act, a taxpayer may elect to amortize over a 5-year period certified coal mine safety equipment. The amortization deduction provided by this provision is in lieu of the depreciation deduction for this equipment. The amortization period begins with the month following the month when the equipment is placed in service or with the succeeding taxable year.

Certified coal mine safety equipment for this purpose means electric face equipment which is required in order to comply with the Federal Coal Mine Health and Safety Act of 1969, which is certified by the Secretary of Interior, and which is placed in service before January 1, 1975. Used electric face equipment also is eligible for this 5-year amortization when certified by the Secretary of Interior as equipment which

is permissible under that Act. The termination date, as in the case of other similar provisions added by this Act, is designed to afford Congress the opportunity to review the effectiveness of the provision and to decide whether or not it is desirable to extend the provision for any additional period.

Effective date.—The provision applies to taxable years ending after December 31, 1969.

Revenue effect.—The revenue effect of this provision is expected to be small.

AA. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

1. Increase in the Personal Exemption (sec. 801 of the Act and secs. 151 and 6013(b)(3)(A) of the code)

Prior law.—Under prior law, the amount of the personal exemption was \$600 for the taxpayer, his spouse and each dependent. Additional exemptions could be claimed by the blind and those over age 65.

General reasons for change.—The personal exemption has remained at the \$600 level since 1948. Rising prices since that time, however, have reduced the real value of the personal exemption and increased the difference between \$600 and the actual cost of supporting a dependent. In addition, the Congress believed that the increase in the personal exemption provides the simplest and most easily understood form of tax relief, the benefit of which is concentrated in the lower and middle income classes where it is needed most.

Explanation of provision.—The Act provides an increase in the personal exemption to \$625 for calendar year 1970 (increasing the exemption to \$650 on July 1, 1970, for withholding tax purposes), to \$650 for 1971, to \$700 for 1972, and to \$750 for 1973 and thereafter. The increase applies to all exemptions, including those for age and blindness as well as exemptions for taxpayers, spouses and dependents. Approximately 2.7 million returns will be made nontaxable because of the \$750 personal exemption (in addition to those made nontaxable by the low-income allowance discussed below).

Effective date.—The increases in the personal exemption provided by the Act are effective on the following dates:

<i>Effective date</i>	<i>Exemption level</i>
Taxable years beginning after Dec. 31, 1969, and before Jan. 1, 1971-----	\$625
Taxable years beginning after Dec. 31, 1970, and before Jan. 1, 1972-----	650
Taxable years beginning after Dec. 31, 1971, and before Jan. 1, 1973-----	700
Taxable years beginning after Dec. 31, 1972-----	750

For taxpayers with fiscal years straddling two calendar years, the applicable exemption is determined by a proration rule which takes into account the number of days in the taxpayer's year falling in each calendar year.

Revenue effect.—The increases in the personal exemption level scheduled by the Act grant individual income taxpayers tax relief amounting to an estimated \$816 million in calendar year 1970, \$1.6 billion in 1971, \$3.3 billion in 1972, and \$4.8 billion in 1973 and thereafter.

2. Increase in the Standard Deduction (sec. 802(a) of the Act and sec. 141 of the code)

Prior law.—Under prior law, a taxpayer in computing taxable income could itemize his deductions or take the larger of the minimum standard deduction or the 10-percent standard deduction. The mini-

imum standard deduction was \$200 plus \$100 for each exemption, and the regular standard deduction was 10 percent of adjusted gross income. Both forms of the standard deduction were limited to \$1,000 (\$500 in the case of a married individual filing a separate return).

General reasons for change.—The 10-percent standard deduction was introduced in 1944 to reduce the complexity of the income tax for the vast majority of taxpayers. Instead of keeping records of deductible personal expenditures and itemizing deductions on their tax returns, more than 82 percent of taxpayers because of this were able to use the simpler standard deduction when it was first introduced. Since that time, higher medical costs, higher interest rates, higher State and local taxes, increased homeownership, and more expensive homes have made it advantageous for more and more taxpayers to shift over to itemized deductions. In addition, itemization had been encouraged by rising incomes which have moved more and more taxpayers beyond the \$10,000 income level where the \$1,000 standard deduction ceiling first becomes applicable. The effect of higher incomes and increased expenses has been to decrease the proportion of returns using the standard deduction from 82 percent in 1944 to 58 percent in 1969, as shown in Table 1 below.

TABLE 1.—PROPORTION OF INDIVIDUAL TAX RETURNS WITH STANDARD DEDUCTION, SELECTED YEARS SINCE 1944 AND ESTIMATED 1969 LEVELS, 1969 LAW

Year	Total number of returns (millions)	Percent with itemized deductions	Percent with standard deduction
1944.....	47.1	17.8	82.2
1951.....	55.4	20.9	79.1
1955.....	58.3	29.0	71.0
1960.....	61.0	39.5	60.5
1963.....	63.9	43.9	56.1
1965.....	67.6	41.2	58.8
1969 (estimated).....	75.7	41.8	58.2

Note: It should be noted that the lower percent with itemized deduction in 1965 was due to the introduction of the minimum standard deduction in 1964.

In 1969, the standard deduction accounted for most of the returns filed for those with adjusted gross incomes below \$3,000, and still accounted for three-fourths of the returns for adjusted gross income levels of \$3,000 to \$5,000. However, upon reaching the \$7,000 to \$10,000 adjusted gross income level the standard deduction accounted for less than half of the returns. For those with adjusted gross incomes between \$10,000 and \$15,000 the standard deduction accounted for only about one-fourth of the returns filed, and above that level it tailed off

quite rapidly, reaching a very small percentage in the \$20,000 to \$50,000 class. These data, by income classes, are shown in table 2 below.

TABLE 2.—ESTIMATED NUMBER AND PERCENTAGE OF TAXABLE AND NONTAXABLE ITEMIZED AND STANDARD DEDUCTION RETURNS, 1969 LEVELS, 1969 LAW

[Number of returns in thousands]

Adjusted gross income class (thousands)	All returns	Standard deduction returns		Itemized deduction returns	
		Number	Percent	Number	Percent
0 to \$3.....	21,318	19,756	92.7	1,562	7.3
\$3 to \$5.....	10,582	7,905	74.7	2,677	25.3
\$5 to \$7.....	10,006	6,064	60.6	3,942	39.4
\$7 to \$10.....	13,867	5,886	42.4	7,981	57.6
\$10 to \$15.....	13,087	3,638	27.8	9,448	72.2
\$15 to \$20.....	3,853	591	15.3	3,263	84.7
\$20 to \$50.....	2,600	226	8.7	2,374	91.3
\$50 to \$100.....	340	10	2.9	330	97.1
\$100 and over.....	95	1	1.0	94	99.0
Total.....	75,748	44,077	58.2	31,671	41.8

Source: Treasury Department.

When the 10-percent standard deduction was first introduced, 10 percent was much closer to the average percentage of income represented by itemized deductions than was the case in 1969—approximately 14 percent in 1944 and 18 percent in 1969. As Table 3 shows, the percentage of itemized deductions to adjusted gross income varied appreciably among income classes—for example, it amounted to over 20 percent in the under \$7,000 adjusted gross income classes and slightly more than 14 percent in the \$50,000 to \$100,000 adjusted gross income class.

TABLE 3.—ITEMIZED DEDUCTIONS AS A PERCENT OF ADJUSTED GROSS INCOME ON ITEMIZED RETURNS, 1969

Adjusted gross income class (thousands) :	Percent
0 to \$3.....	40.0
\$3 to \$5.....	27.4
\$5 to \$7.....	21.9
\$7 to \$10.....	20.0
\$10 to \$15.....	17.7
\$15 to \$20.....	16.2
\$20 to \$50.....	14.6
\$50 to \$100.....	14.5
\$100 and over.....	18.8
All classes.....	17.9

Explanation of provision.—The Act increases the regular standard deduction to 13 percent with a \$1,500 ceiling in 1971, to 14 percent with a \$2,000 ceiling in 1972, and to 15 percent with a \$2,000 ceiling for 1973 and thereafter. For married taxpayers filing separate returns, the ceilings are one-half the above amounts.

Nearly 34 million returns (at 1969 levels) will benefit as a result of the increase in the standard deduction to 15 percent with a \$2,000 ceiling. This constitutes slightly more than half of all taxable returns. As a result of this change alone, some 8.7 million taxpayers presently itemizing their deductions, or 27 percent of the total, can be expected to shift to the standard deduction, raising the proportion of taxpayers using this deduction from 58 percent to nearly 70 percent. This is without regard to the impact of the low-income allowance (minimum standard deduction) described below.

Effective date.—As indicated above, the successive increases in the standard deduction provided by the Act take effect in calendar years 1971, 1972, and 1973. For taxpayers with fiscal years straddling two calendar years, the applicable standard deduction is determined by a proration rule which takes into account the number of days in the taxpayer's year falling in each calendar year.

Revenue effect.—The increases in the standard deduction scheduled by the Act grant individual income taxpayers tax relief amounting to an estimated \$1.21 billion in calendar year 1971, \$1.36 billion in 1972, and \$1.64 billion in 1973 and thereafter.

3. Low-Income Allowance (sec. 802 of the Act and secs. 141 and 143 of the code)

Prior law.—Under prior law, the minimum standard deduction was \$200 plus \$100 for each personal exemption up to a maximum of \$1,000.

General reasons for change.—Inflationary price increases have had their most severe impact in the erosion of the already inadequate purchasing power of the poor. In addition, recent studies of the economic conditions of the poor by the Department of Health, Education, and Welfare have indicated that, even with the minimum standard deduction under prior law, many persons with incomes below the poverty level were subject to tax. Moreover, substantial tax burdens were imposed on those with incomes immediately above the poverty levels. In 1969, there were some 5.2 million taxable returns at or below the recognized poverty levels.

Explanation of provision.—Over a period of three years the Act revises the prior minimum standard deduction of \$200 plus \$100 per exemption with a \$1,000 limit to a flat \$1,000 minimum standard deduction. The new minimum standard deduction is \$1,100 in 1970, \$1,050 in 1971, and \$1,000 in 1972 and thereafter.¹

These amounts were selected to insure that, in combination with the increased personal exemption, persons below the poverty level would not be subject to Federal income tax. For example, the income level at which taxation begins in the case of a single person is raised from the \$900 of prior law to \$1,725 in 1970, to \$1,700 in 1971 and 1972, and to \$1,750 in 1973 and thereafter when the personal exemption is to be \$750.

In 1970 and 1971, the new minimum standard deduction or low-income allowance consists of a "basic allowance" (the former minimum standard deduction) of \$200 plus \$100 per exemption with a \$1,000 limit and an "additional allowance." The "additional allow-

¹ For 1970 and 1971, a husband and wife filing separate returns (except in the case of an abandoned spouse described subsequently) do not receive an "additional allowance." They are limited to the "basic allowance" or the minimum standard deduction of prior law, which, for married couples filing separate returns, was \$100 per taxpayer plus \$100 per exemption, up to a maximum of \$500. For 1972, and later years, however, the minimum standard deduction for a husband and wife filing separate returns is \$500 each.

ance" (for families with 8 or fewer exemptions) is the difference between \$1,100 (\$1,050 in 1971) and the basic allowance. That is, the "additional allowance" adds a sufficient amount to the basic allowance so that the tax-free income level apart from personal exemptions in the case of each family is \$1,100 (\$1,050 in 1971).² Thus, the additional allowance for a husband and wife is \$700 in 1970 (\$1,100 less the basic allowance of \$400) and \$650 in 1971 (\$1,050 less \$400).

For 1970 and 1971, the "additional allowance" provided by the Act is "phased out" as the income of the taxpayer increases above the nontaxable levels. In 1970, for each \$2 of additional adjusted gross income above the nontaxable levels (\$1,100 plus \$625 for each exemption), the additional allowance is reduced by \$1.³ In 1971, the additional allowance is reduced by \$1 for every \$15 of additional income above the nontaxable level.⁴ For 1972 and later years there is no "phaseout" and the low-income allowance becomes a flat \$1,000 minimum standard deduction.

Married couples filing separate returns for 1970 and 1971 are limited to a minimum standard deduction of \$100 plus \$100 per exemption with a \$500 limit and do not receive the additional allowance. For 1972 and thereafter, they each are limited to a \$500 minimum standard deduction or one-half the minimum available to those filing a joint return. However, to make provision for a family abandoned by one of the parents, the Act provides that a married individual, under certain conditions, may obtain the full low-income allowance even though not filing a joint return.⁵ To receive this treatment the individual must not file a joint return, but must maintain a household which is the principal place of abode of one or more dependents for more than one-half of the taxable year. The dependent in question must be a son or daughter (or step-son or step-daughter) for which the individual is entitled to a dependency exemption. In addition, the individual must furnish more than half the cost of maintaining the household and during the entire taxable year the individual's spouse must not be a member of the household in question.

Approximately 11.8 million returns are expected to benefit in 1970 from the low-income allowance of which 5.2 million are expected to become nontaxable. In 1972, when the phaseout is no longer applicable, 31.5 million returns (at 1969 levels) are expected to benefit from the \$1,000 minimum standard deduction; of these 4.8 million are expected to be nontaxable. (Taking into account the \$750 personal exemption and the increased percentage standard deduction which are

² In the case of a single person in 1970 there is a \$300 basic allowance plus an \$800 additional allowance (\$750 in 1971): in the case of a family unit of 2 members, the amount added to the \$400 basic allowance is \$700 in 1970 and \$650 in 1971. As the amount of the basic allowance increases (by \$100 for each exemption) the additional allowance added in order to maintain a uniform \$1,100 (\$1,050 in 1971) of tax-free income per family unit (without regard to personal exemptions), decreases by \$100.

³ For example, the \$800 additional allowance made available in the case of single persons is gradually eliminated as income rises above \$1,725 and terminates at an income level of \$3,325 (an income span of \$1,600); above the \$3,271 income level, the single person would switch to the 10-percent standard deduction which would be larger than the remaining low-income allowance.

⁴ For example, in 1971, the additional allowance of \$750 for a single person is decreased by \$1 for every \$15 of additional income above the nontaxable level of \$1,050 plus \$650. Thus, for a single person in 1971, the reduction of the additional allowance begins at \$1,700 and ends at \$11,250 (although above \$5,915, the 13-percent standard deduction available in 1971 is larger than the remaining low-income allowance).

⁵ In addition, such an individual when electing the percentage standard deduction may deduct the same amount as a married couple, rather than only the amount provided for a married individual filing separately and may use the new single person rate schedule (if he or she qualifies for head-of-household status by maintaining a dependent child in the household for the entire taxable year he or she may use the tax rates for head of household)

fully effective in 1973, 63.2 million returns are expected to benefit from the changes, of which 7.6 million are expected to be made nontaxable.)

Part of those who benefit from the new minimum standard deduction are the 4.4 million returns which are expected to switch from itemized deductions to the standard deduction in response to the \$1,000 minimum standard deduction. As a result of the combined effect of the minimum standard deduction and the percentage standard deduction (described above), when fully effective in 1973, 11 million taxpayers are expected to shift over from itemized deductions to the standard deduction. This is expected to increase the proportion using the standard deduction to about 70 percent of all returns.⁶ The number and proportion of returns expected to switch to the standard deduction, and the number and percentage of returns expected to be using the standard deduction after switching, as a result of the combination of these provisions is shown in table 4 below.

⁶ The 70 percent figure takes into consideration the reduction in returns filed because of the liberalization of the filing requirement (discussed below under section DD, *Miscellaneous Administrative Provisions*).

TABLE 4.—INDIVIDUAL INCOME TAX RETURNS WITH STANDARD DEDUCTION AND WITH ITEMIZED DEDUCTIONS UNDER PRIOR LAW, NUMBER OF RETURNS WITH TAX DECREASE AND NUMBER OF RETURNS SWITCHING TO THE STANDARD DEDUCTION UNDER THE STANDARD DEDUCTION PROVISIONS (BUT WITHOUT THE INCREASED EXEMPTION PROVISION) OF THE TAX REFORM ACT OF 1969 WHEN FULLY EFFECTIVE¹ 1969 LEVELS, BY ADJUSTED GROSS INCOME CLASS

[Number of returns in thousands]

Adjusted gross income class	Returns under prior law						Returns under the Tax Reform Act of 1969								
	Taxable and nontaxable returns			Returns with tax decrease			Returns switching from itemizing deductions to the standard deduction			Returns with itemized deductions after switching			Returns with standard deduction after switching		
	With itemized deductions		With standard deduction	Percent of total		Percent of total	Number		Percent of prior-law taxable returns	Number		Percent	Number		Percent
	Total number	Number	Percent of total	Total taxable returns	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	
0 to \$3,000	21,318	1,562	7.3	19,756	92.7	10,053	99.3	9,983	89.3	1,072	68.6	490	2.3	20,828	97.7
\$3,000 to \$5,000	10,582	2,677	25.3	7,905	74.7	9,562	89.1	8,522	88.1	1,415	52.9	1,262	11.9	9,320	88.1
\$5,000 to \$7,000	10,006	3,942	39.4	6,064	60.6	9,779	73.8	7,219	73.8	1,211	30.7	2,731	27.3	7,275	72.7
\$7,000 to \$10,000	13,867	7,981	57.6	5,886	42.4	13,815	59.0	8,157	59.0	2,549	29.4	5,632	40.6	8,235	59.4
\$10,000 to \$15,000	13,087	9,448	72.2	3,638	27.8	13,082	58.0	7,317	56.0	3,674	38.9	5,774	44.1	7,312	55.9
\$15,000 to \$20,000	3,853	3,263	84.7	591	15.3	3,852	58.4	1,516	39.4	530	28.5	2,333	60.6	1,521	39.5
\$20,000 to \$50,000	2,600	2,374	91.3	226	8.7	2,594	22.9	594	22.9	383	16.1	1,991	76.6	609	23.4
\$50,000 to \$100,000	340	330	97.1	10	2.9	340	6.5	22	6.5	12	3.6	318	93.5	22	6.5
\$100,000 and over	95	94	99.0	1	1.0	95	2.1	2	2.1	1	1.1	93	97.9	2	2.1
Total	75,748	31,671	41.8	44,077	58.2	63,152	68.6	43,331	68.6	11,048	34.9	20,624	27.2	55,124	72.8

¹ 1973 and thereafter: Minimum standard deduction of \$1,000 and percentage standard deduction of 15 percent with \$2,000 ceiling; excludes effect of \$750 exemption.

² Taxable and nontaxable returns without reduction for decrease due to change in filing requirements under the Tax Reform Act.

Note: Details do not necessarily add to totals because of rounding.

Taxpayers using the low-income allowance will generally not have to compute the low-income allowance or the "phaseout" because the optional tax tables (which are to be extended to cover incomes up to \$10,000) will reflect the calculations in the tax shown. The increase in the income level below which the optional tax table can be used from \$5,000 to \$10,000 will also benefit taxpayers using the percentage standard deduction. This increase in the income level will substantially simplify tax computation for roughly 10 million additional returns.

Effective date.—As indicated above, the successive changes in the low income allowance (minimum standard deduction) take effect in calendar years 1970, 1971, and 1972. For taxpayers with fiscal years straddling two calendar years, there is a proration of the applicable low-income allowance according to the number of days in each calendar year.

Revenue effect.—The low-income allowance which the Act provides grants individuals income tax reductions amounting to an estimated \$625 million in calendar year 1970, \$1.59 billion in 1971, and \$2.06 billion in 1972 and thereafter.

4. Tax Treatment of Single Persons (sec. 803 of the Act and secs. 1, 2, and 3 of the code)

Prior law.—Since the Revenue Act of 1948, married couples filing joint returns have had the option of being taxed under the split-income provision. This, in effect, taxed a married couple as if it were composed of two single individuals each with one-half the couple's combined income. This 50-50 split of income between the spouses for tax purposes generally produced a lower tax than any other division of income since the application of the graduated tax rates separately to each of the two equal parts comprising the couple's income kept the total income in lower tax brackets.

Single people have not had a comparable income splitting privilege. As a result, they generally paid higher taxes than married couples at the same income levels.

In 1951, a head-of-household provision was enacted to grant partial income splitting benefits to widows, widowers, and single persons with dependents in their households. Individuals who qualify under this provision were allowed approximately one-half of the income-splitting benefits given to married couples. These heads-of-households used a separate tax rate schedule which, at any given level of income, produced a tax liability about halfway between the tax paid by a married couple filing a joint return and a single individual.

General reasons for change.—Under prior law, the tax rates imposed on single persons were quite heavy relative to those imposed on married couples at the same income level; at some income levels a single person's tax was as much as 42.1 percent higher than the tax paid on a joint return with the same amount of taxable income. The Congress believed that some difference between the rate of tax paid by single persons and joint returns was appropriate to reflect the additional living expenses of married taxpayers but that the prior law differential of as much as 42 percent (the result of income splitting) could not be justified on this basis.

Explanation of provision.—The Act provides a new, lower rate schedule for single persons effective in 1971. The new rate schedule is shown below along with the rate schedule under prior law. This rate

schedule is designed to provide tax liabilities for single persons which are 17 to 20 percent above those for married couples for taxable incomes of between \$14,000 and \$100,000, with the maximum differential of 20 percent being reached for an income level of \$24,000 as shown in table 5 below. (Under prior law, the difference was as great as 42 percent at \$24,000 and \$28,000.) As income falls below \$14,000 where income splitting is less beneficial, the excess of single persons' taxes over those of married couples gradually decreases. This is also true above \$100,000 where the benefits of income splitting become less significant.

TAX RATES FOR UNMARRIED INDIVIDUALS¹

1969-1970				1971 and thereafter			
Taxable income		Tax	Of excess over	Taxable income		Tax	Of excess over
Over	Not over			Over	Not over		
\$500	\$500	14%	-----	\$500	\$500	14%	-----
\$1,000	\$1,000	\$70+15%	\$500	\$500	\$1,000	\$70+15%	\$500
\$1,500	\$1,500	\$145+16%	\$1,000	\$1,000	\$1,500	\$145+16%	\$1,000
\$2,000	\$2,000	\$225+17%	\$1,500	\$1,500	\$2,000	\$225+17%	\$1,500
\$2,500	\$4,000	\$310+19%	\$2,000	\$2,000	\$4,000	\$310+19%	\$2,000
\$4,000	\$6,000	\$690+22%	\$4,000	\$4,000	\$6,000	\$690+21%	\$4,000
\$6,000	\$8,000	\$1,130+25%	\$6,000	\$6,000	\$8,000	\$1,110+24%	\$6,000
\$8,000	\$10,000	\$1,630+28%	\$8,000	\$8,000	\$10,000	\$1,590+25%	\$8,000
\$10,000	\$12,000	\$2,190+32%	\$10,000	\$10,000	\$12,000	\$2,090+27%	\$10,000
\$12,000	\$14,000	\$2,830+36%	\$12,000	\$12,000	\$14,000	\$3,210+29%	\$12,000
\$14,000	\$16,000	\$3,550+39%	\$14,000	\$14,000	\$16,000	\$4,510+31%	\$14,000
\$16,000	\$18,000	\$4,330+42%	\$16,000	\$16,000	\$18,000	\$3,830+34%	\$16,000
\$18,000	\$20,000	\$5,170+45%	\$18,000	\$18,000	\$20,000	\$4,510+36%	\$18,000
\$20,000	\$22,000	\$6,070+48%	\$20,000	\$20,000	\$22,000	\$5,230+38%	\$20,000
\$22,000	\$26,000	\$7,030+50%	\$22,000	\$22,000	\$26,000	\$5,990+40%	\$22,000
\$26,000	\$32,000	\$9,030+53%	\$26,000	\$26,000	\$32,000	\$7,590+45%	\$26,000
\$32,000	\$38,000	\$12,210+55%	\$32,000	\$32,000	\$38,000	\$10,290+50	\$32,000
\$38,000	\$44,000	\$15,510+58%	\$38,000	\$38,000	\$44,000	\$13,290+55%	\$38,000
\$44,000	\$50,000	\$18,990+60%	\$44,000	\$44,000	\$50,000	\$16,590+60%	\$44,000
\$50,000	\$60,000	\$22,590+62%	\$50,000	\$50,000	\$60,000	\$20,190+62%	\$50,000
\$60,000	\$70,000	\$28,790+64%	\$60,000	\$60,000	\$70,000	\$26,390+64%	\$60,000
\$70,000	\$80,000	\$35,190+66%	\$70,000	\$70,000	\$80,000	\$32,790+66%	\$70,000
\$80,000	\$90,000	\$41,790+68%	\$80,000	\$80,000	\$90,000	\$39,390+68%	\$80,000
\$90,000	\$100,000	\$48,590+69%	\$90,000	\$90,000	\$100,000	\$46,190+69%	\$90,000
\$100,000	-----	\$55,490+70%	\$100,000	\$100,000	-----	\$53,000+70%	\$100,000

¹ Other than surviving spouses and heads of households.

A new rate schedule is also provided for heads-of-households which is half way between the new rate schedule for single persons and the rate schedule for married couples.

The prior law rate schedule for single persons will continue to be used for married couples filing separate returns and for estates and trusts. The prior law single person rate schedule was retained for married persons filing separate returns because if each spouse were permitted to use the new tax rate schedule for single persons, many (especially those in community property states) could arrange their affairs and income in such a way that their combined tax would be less than that on a joint return.

With the new rate schedule for single persons, married couples filing a joint return will pay more tax than two single persons with the same total income. This is a necessary result of changing the income-splitting relationship between single and joint returns. Moreover, it is justified on the grounds that although a married couple has greater living expenses than a single person and hence should pay less tax, the couple's living expenses are likely to be less than those of two single persons and therefore the couple's tax should be higher than that of two single persons.

TABLE 5

COMPARISON OF THE TAX PAID BY SINGLE PERSONS WITH THE TAX PAID ON JOINT RETURNS WITH THE SAME AMOUNT OF TAXABLE INCOME UNDER PRIOR LAW AND PRESENT LAW

Taxable income	Joint returns: Tax under prior law and present law	Single returns: Tax under—		Excess of single return tax over joint return tax as a percent of joint return tax	
		Prior law	Present law	Prior law	Present law
\$1,000.....	\$140	\$145	\$145	3.6	3.6
\$2,000.....	290	310	310	6.9	6.9
\$3,000.....	450	500	500	11.1	11.1
\$4,000.....	620	690	690	11.3	11.3
\$8,000.....	1,380	1,630	1,590	18.1	15.2
\$12,000.....	2,260	2,830	2,630	25.2	16.4
\$16,000.....	3,260	4,330	3,830	32.8	17.5
\$20,000.....	4,386	6,070	5,230	38.6	19.4
\$24,000.....	5,660	8,030	6,790	41.9	20.0
\$28,000.....	7,100	10,090	8,490	42.1	19.6
\$32,000.....	8,660	12,210	10,290	41.0	18.8
\$36,000.....	10,340	14,410	12,290	39.4	18.9
\$40,000.....	12,140	16,670	14,390	37.3	18.5
\$44,000.....	14,060	18,990	16,590	35.1	18.0
\$48,000.....	16,060	21,390	18,990	33.2	18.2
\$52,000.....	18,060	23,830	21,430	31.9	18.7
\$56,000.....	20,180	26,310	23,910	30.4	18.5
\$64,000.....	24,420	31,350	28,950	28.4	18.6
\$76,000.....	31,020	39,150	36,750	26.2	18.5
\$88,000.....	37,980	47,230	44,830	24.4	18.0
\$100,000.....	45,180	55,490	53,090	22.8	17.5
\$120,000.....	57,580	69,490	67,090	20.7	16.5
\$140,000.....	70,380	83,490	81,090	18.6	15.2
\$160,000.....	83,580	97,490	95,090	16.6	13.8
\$180,000.....	97,180	111,490	109,090	14.7	12.3
\$200,000.....	110,980	125,490	123,090	13.1	10.9

Note: The tax liabilities for single persons under present law are computed on the basis of the new tax-rate schedule provided by the Act which is effective in 1971.

Effective date.—The lower tax rate schedule provided for single persons under the Act is effective for taxable years beginning after December 31, 1970. For taxpayers with fiscal years straddling two calendar years, there is a proration of the tax rates applicable according to the number of days in each calendar year.

Revenue effect.—The new tax rate schedule grants single persons tax relief amounting to an estimated \$420 million a year beginning in calendar 1971.

5. 50-Percent Maximum Tax on Earned Income (sec. 804 of the Act and sec. 1348 of the code)

Prior law.—Under present and prior law, the individual income tax rates reach a maximum of 70 percent for taxable income in excess of \$100,000 for single persons and \$200,000 for joint returns. Under prior law, the 70-percent rate was generally applicable to all taxable income other than capital gains subject to the alternative rate of 25 percent.

General reasons for change.—The Congress concluded that extremely high rates of tax, particularly in the case of earned income, are unrealistic and tend to create distortions in our tax system. It was concluded that a 50-percent maximum marginal rate on earned income would be an effective method of reducing the disincentive effect of high tax rates in the case of earned income.

In addition, however, the 50-percent limit on the tax rate applicable to earned income was adopted as a means of reducing the pressure for the use of tax loopholes. The Congress concluded that one of the most

effective ways to prevent the use of tax avoidance devices is to reduce the incentive for engaging in such activities by reducing the high tax rates on earned income but only where tax avoidance devices generally are not used. The Congress concluded that a 50-percent limit on tax rates applicable to earned income (but with a reduction in income eligible for this treatment by the amount of tax preferences otherwise obtained) would substantially reduce the incentive to engage in otherwise unprofitable operations merely because of the tax consequences. It was believed that such modifications would reduce the time and effort devoted to "tax planning" at the expense of pursuing normal business operations. It was believed that this reduction of effort will contribute to maintaining the integrity of the tax system and discourage the use of tax avoidance devices. Moreover, since the disincentive effect of high tax rates on effort is greatest in the case of earnings, the Congress concluded that with limited revenues available for this purpose, it would be most efficient to apply the 50-percent limit to earned income only.

Explanation of provision.—The Act provides that the maximum marginal tax rate applicable to an individual's earned income is not to exceed 50 percent. This is, in effect, an alternative tax computation for earned income under which earned income in the taxable income brackets where the tax rate would otherwise be greater than 50 percent is subject to a flat 50 percent rate. For taxable years beginning after December 31, 1970, and before January 1, 1972, the maximum rate is 60 percent and for taxable years beginning on January 1, 1972, or later, the maximum rate is 50 percent.

Earned taxable income is generally the same proportion of total taxable income (but not in excess of 100 percent) as earned net income is of adjusted gross income. Thus, if 80 percent of an individual's adjusted gross income is earned net income, then 80 percent of his taxable income is generally considered earned taxable income. In the case where a taxpayer has tax preference income, the "tentative" earned taxable income as determined above is reduced for purposes of the 50-percent limit by tax preferences in excess of \$30,000 in the current year or the average tax preferences in excess of \$30,000 for the current year and the prior four years, whichever is greater.

Total tax liability is computed in two stages. The determination of the tax on income that is not eligible for the 50-percent limitation is the first stage. This is accomplished by computing the tax at regular rates on total taxable income and then subtracting the tax at regular rates on earned taxable income (which is treated as the first income subject to tax, as shown in steps 9 through 11 in the example below). In the second stage, the tax on earned taxable income is calculated as the sum of the regular tax on the amount of taxable income above which the tax rate exceeds 50 percent (\$52,000 for joint returns and \$38,000 for single returns) and 50 percent of earned taxable income in excess of those amounts (step 12 in the example below). The total tax liability is simply the tax on earned taxable income plus the separately computed tax on income not eligible for the 50 percent limit (step 13 below).

*Computation of tax under 50-percent maximum rate on earned income*¹

1. Adjusted gross income (AGI)-----		\$150,000
Dividends -----	30,000	
Earned net income-----	120,000	
2. Tax preferences ² -----		(5,000)
3. Deductions and exemptions-----		25,000
4. Taxable income (1-3)-----		125,000
5. Percent earned net income is of AGI ($\$120,000 \div \$150,000$)-----	(80 percent)	
6. "Tentative" earned taxable income 80 percent \times \$125,000-----		100,000
7. Average tax preferences ² for the current year and the prior 4 years minus \$30,000-----		13,000
8. Earned taxable income (6-7)-----		87,000
9. Regular tax on taxable income (4)-----		60,780
10. Regular tax on earned taxable income (8)-----		37,400
11. Tax on income not eligible for the 50-percent limit (9-10)-----		23,380
12. Tax under 50-percent limit on earned taxable income (8)-----		35,560
(a) Tax on taxable income on which the tax rate does not exceed 50 percent (that is, tax on \$52,000) --	18,060	
(b) 50 percent of earned taxable income (8) in excess of \$52,000 ($\$87,000$ less $\$52,000$ equals $\$35,000$) --	17,500	
13. Total tax (11+12)-----		58,940

¹ Joint return.

² Tax preference of \$5,000 for the current year are assumed not to be in adjusted gross income. The 5-year average of tax preferences is assumed to be \$43,000, which exceeds current year tax preferences.

Tax preferences for the purpose of determining earned taxable income are the same as those for individuals under the minimum tax (see Section G, *Minimum Tax*, above). The reduction of the benefit of the 50-percent limit for tax preference income in excess of \$30,000 was adopted to prevent individuals with substantial tax preferences who pay a low effective rate of tax from reducing their tax rate further by using the 50-percent limit. The reduction of earned taxable income eligible for the 50-percent limit by the greater of tax preferences in excess of \$30,000 in the current year or the average of the current year and the four prior years was adopted to prevent manipulation through the receipt of preference income and earned income in alternate years so as to pay a lower rate of tax over the period.

Earned net income is earned income reduced by any deductions properly attributable to it.

Earned income generally includes wages, salaries, professional fees or compensation for personal services, including royalty payments to authors and inventors and, in the case of a taxpayer engaged in a trade or business where both personal services and capital are a material income-producing factor, a reasonable amount but not more than 30 percent of his share of the net profits of the business.

For purposes of the 50-percent limit, earned income does not include lump-sum distributions from employees' trusts (sec. 402(a)(2)(A) as amended) or employee annuity plans (sec. 403(a)(2)(A) as amended) which are eligible for capital gains treatment or eligible for the limitation of tax provided by special averaging rules (sec. 72(n) as amended). Nor does it include penalty distributions from owner-employee plans (sec. 72(m)(5)). In addition, earned income does not include deferred compensation (within the meaning of sec. 404). Deferred compensation for this purpose does not include amounts

received in the year following the first taxable year in which the taxpayer's right to receive such amounts is not subject to a substantial risk of forfeiture.

The 50-percent limit is not available to taxpayers who elect income averaging in part to avoid the complexity that would be added to both provisions if they could be used together. In addition, with respect to earned income, one of these provisions will generally produce a lower tax than the other and would be elected by the taxpayer in any case. Nor is the 50-percent limit available to married taxpayers who file separate returns in order to prevent manipulation of income for this purpose between husband and wife.

Effective date.—The 60-percent rate ceiling applicable to earned income is effective for taxable years beginning after December 31, 1970; the 50-percent rate ceiling is effective for taxable years beginning after December 31, 1971.

Revenue effect.—The provision involves an estimated reduction in tax liabilities of \$75 million in calendar year 1971 and \$170 million in calendar year 1972 and thereafter.

6. Collection of Income Tax at Source on Wages (sec. 805 of the Act and sec. 3402 of the code)

Prior law.—Prior law provided withholding tables and a percentage withholding method which incorporated the \$600 personal exemption, the minimum standard deduction, the 10 percent standard deduction and the tax rates including the 10 percent surcharge.

General reasons for change.—To maintain the correspondence between tax liability and tax withheld, it was necessary to incorporate into the withholding rates and tables the changes made by the Act with respect to the minimum standard deduction, the 10 percent standard deduction, the personal exemption, the new tax rates for single persons and the reduction and removal of the surcharge.

Explanation of provision.—The Act provides new percentage method withholding rates and requires the Secretary of the Treasury to prescribe wage bracket withholding tables based on the withholding rates in the Act. The percentage method of withholding incorporates:

for all of 1970, the \$1,100 low-income allowance (with the phaseout); for the first six months of 1970, the 5 percent surcharge, and for the last six months of 1970, the \$650 personal exemption;

for 1971 the \$1,050 low-income allowance (with the phaseout), the 13 percent standard deduction (with a \$1,500 ceiling), the new tax rates for single persons, and the \$650 personal exemption;

for 1972, the \$1,000 minimum standard deduction (without the phaseout), the 14 percent standard deduction (with a \$2,000 ceiling), the new tax rates for single persons and the \$700 personal exemption;

for 1973 and thereafter, the \$1,000 minimum standard deduction, the 15 percent standard deduction (with a \$2,000 ceiling), the new rates for single persons, and the \$750 personal exemption.

The withholding rates and tables have been completely restructured because of the low-income allowance and elimination of the surcharge provided by the Act.⁷

Effective date.—The first change in withholding under the Act applies to wages paid after December 31, 1969.

7. Provision for Flexibility in Withholding Procedures (sec. 805(d) of the Act and sec. 3402(h) of the code)

Prior law.—Under prior law, employers were limited in methods of computing wage withholding to the withholding tables or percentage methods specified in the code or essentially equivalent methods. They were permitted to withhold on the basis of average wages paid within a calendar quarter but prior law did not permit them to use average wages over a longer period.

General reasons for change.—Employers in some cases have devised withholding methods, frequently in conjunction with computerized payroll operations, which produce approximately the same amount of withholding as the regular methods but are substantially easier for employers to administer. Under prior law, the Internal Revenue Service had no authority to permit employers to use such methods. There also are a number of types of employment situations where the prior permissible withholding methods did not accurately match tax liability and tax withheld. This was true, for example, where wage payments vary significantly in size from one pay period to another.

Explanation of provision.—The Act provides employers greater flexibility in their withholding procedures by authorizing the Secretary of the Treasury to permit them to use any method which results in substantially the same amount of withholding as the regular methods. The Act also permits employers to “annualize” wage payments for withholding purposes. This will make the computation of withholding easier for many large employers whose payroll computations are handled by a computer. This provision is an extension of the prior sec. 3402(h) which permitted withholding on average wages for a calendar quarter but, in contrast to prior law, does not require that the amount of withholding for the year (quarter) be the same as required by the regular methods.

⁷ In some instances, matching withholding to the new tax liability creates higher withholding in 1970 than in 1969 even though tax liability for 1970 is lower.

This increase in withholding is caused almost entirely by two factors both of which result from the new low-income allowance (minimum standard deduction). The first of these is a change in the withholding structure which corrects previous underwithholding for many taxpayers using the 10 percent standard deduction. Because of the way in which the prior law minimum standard deduction was incorporated into the withholding structure, these taxpayers received the 10 percent standard deduction plus part of the minimum standard deduction for withholding purposes and thus had too little tax withheld. The new low-income allowance corrects this source of underwithholding.

The second cause of the increase in withholding is the phaseout of the low-income allowance as income increases above the tax-exempt levels in 1970 and 1971. The amount subject to the phaseout (and hence the size of the low-income allowance) depends on the number of personal exemptions claimed. To avoid a separate withholding schedule for each number of exemptions, the Internal Revenue Service based the withholding schedules on the most common number of exemptions: one for single persons and four in the case of married couples. Thus, when the number of exemptions claimed exceeds the most common number used by the Internal Revenue Service in computing the withholding tables, too much of the low-income allowance is phased out. This tends to create an increase in withholding which represents over-withholding.

In the last half of 1970, as a result of the increase in the personal exemption from \$600 to \$650 and the elimination of the surcharge, any increase in withholding is substantially reduced but not eliminated. It will be completely eliminated in 1971 when the 13 percent standard deduction and the slower phaseout of the low-income allowance become effective.

The low-income allowance on the other hand tends to create underwithholding in the case of a husband and wife who are both subject to withholding. The withholding system gives each of them the low-income allowance even though they are entitled to only one allowance when filing their return. This “doubling up” can be corrected by neither spouse claiming a personal exemption.

Under the annualizing method, an employer can: (1) multiply the amount of wages for one payroll period by the number of periods of similar length in the year to obtain the approximate total annual wages; (2) determine the annual amount of withholding required on the total wages from (1); and (3) divide the annual withholding amount by the number of payroll periods and withhold the resulting amount for the payroll period.

To deal with cases where wage payments are quite irregular, the Act provides for withholding on the basis of cumulative wages and cumulative withholding.

Another type of earning pattern that could result in overwithholding under prior law is employment for only part of the year as in the case, for example, of teachers and professional athletes. The Act authorizes the Secretary of the Treasury to issue regulations which permit withholding methods that withhold the correct amount of tax for the entire year. This flexibility is intended to permit the Secretary of the Treasury to authorize use of withholding methods to deal with cases such as part-year employment if the Internal Revenue Service is able to develop methods that are administratively satisfactory.

Effective date.—This provision applies to wages paid after December 31, 1969.

8. Additional Withholding Allowances for Excess Itemized Deductions (sec. 805(e) of the Act and sec. 3402(m) of the code)

Prior law.—Under prior law, taxpayers who estimated they would have large itemized deductions and wished to reduce overwithholding could claim an additional exemption for withholding purposes for each full \$700 of itemized deductions above a threshold level (10 percent of the first \$7,500 of estimated wages and 17 percent of any remainder). The estimated itemized deductions taken into account could be no larger than actual itemized deductions for the prior year.

General reasons for change.—The requirement that estimated itemized deductions be no larger than actual deductions for the preceding year effectively prevented the provision from operating in the first year in which the taxpayer had excess itemized deductions even where the existence of these deductions was clear and did not need to be verified by similar experience in a prior year. This seemed unnecessarily restrictive as did the rule that a withholding allowance (exemption) could not be claimed for itemized deductions which exceeded the threshold level by less than \$700 even though they caused overwithholding. Also, because of the increase in the standard deduction from 10 to 15 percent, the 10 percent threshold needed to be raised.

Explanation of provision.—The Act eliminates the prior year requirement for excess itemized deductions in cases where the excess itemized deductions are substantiated by a court order (such as one providing for the payment of alimony) or by other evidence which verifies their existence. Thus, estimated itemized deductions for the year may equal the total of the itemized deductions (or standard deduction) claimed in the prior year plus itemized deductions in excess of that amount which are demonstrably attributable to an identifiable event during the estimation year or the prior year. The Act also increases the amount of excess itemized deductions for which a withholding allowance is permitted from \$700 to \$750 (the new level of the personal exemption) and changes prior law to permit a full

allowance for a fractional allowance of one-half or more. In addition, the 10 and 17 percent threshold of prior law is replaced by a 15 percent threshold.

Effective date.—This provision applies to wages paid after December 31, 1969.

9. Certification of Nontaxability for Withholding Tax Purposes (sec. 805(f) of the Act and sec. 3402(n) of the code)

Prior law.—Prior law did not excuse employees from withholding on their wages or salaries if their incomes during the period of their employment were above specified levels even though they knew, for other reasons, that they would have no tax liability for the year.

General reasons for change.—Because wage withholding tables are based on the assumption that an employee will work throughout the entire year, in order to receive the full value of his personal exemptions and the new low-income allowance for withholding purposes he must, in fact, work for most of the year. Many taxpayers who work only a part of the year have tax withheld from their wages even though they have no tax liability for that year. Consequently, these employees must file a tax return and claim a refund for this excess withholding.

This represents a problem, especially for students who work part-time during the summer but whose incomes fall below the new levels at which tax begins under the Act. These are substantially higher than under prior law because of the low-income allowance (minimum standard deduction) and higher personal exemption provided by the Act. In addition, the withholding rates and tables are based on the assumption that the taxpayer does not have large itemized deductions (except for the special provision discussed in item 8 above). As a result, some taxpayers with large itemized deductions also find themselves in a nontaxable status even though there may have been significant withholding in their cases. The Congress concluded that, in conjunction with the increase in the income level at which filing a return is required, it would be appropriate to relieve individuals from filing a tax return solely to obtain a refund of their excess withholding.

Explanation of provision.—The Act provides that an individual is not to be subjected to withholding of Federal income tax if he files with his employer a withholding exemption certificate which certifies that he expects to have no Federal income tax liability for the current year, and, in fact, had no income tax liability in the prior year.

In conjunction with the higher filing requirement, this certification provision could potentially relieve as many as 10 million persons from overwithholding although it is unlikely that all those potentially eligible will take advantage of this procedure.

The reduction in the number of returns filed and refunds processed as a result of this provision represents a saving of time and effort for taxpayers and also a substantial administrative saving to the Internal Revenue Service.

Effective date.—This provision applies to wages paid after April 30, 1970.

10. Withholding on Supplemental Unemployment Compensation Benefits (sec. 805(g) of the Act and sec. 3402(o) of the code)

Prior law.—Under prior law, supplemental unemployment compensation benefits were not subject to withholding because they did not constitute wages or remuneration for services.

General reasons for change.—Supplemental unemployment compensation benefits (SUB) paid by employers are generally taxable income to the recipient. Consequently, the absence of withholding on these benefits may require a significant final tax payment by the taxpayer receiving them. Congress concluded that although these benefits are not wages, since they are generally taxable payments they should be subject to withholding to avoid the final tax payment problem for employees.

Explanation of provision.—The Act requires the payor of taxable supplemental unemployment compensation benefits to withhold Federal income tax from these payments. The withholding requirements applicable to withholding on wages are to apply to these nonwage payments.

For purposes of withholding, supplemental unemployment compensation benefits are defined to include benefits which are paid to an employee pursuant to a plan to which the employer is a party because of the employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions but only to the extent such benefits are subject to tax.

Effective date.—This provision applies to supplemental unemployment compensation payments made after December 31, 1970.

11. Voluntary Withholding on Payments Not Defined as Wages (sec. 805(g) of the Act and secs. 3402 (o) and (p) of the code)

Prior law.—Prior law specifically excluded certain types of remuneration from the definition of wages and made no provision for withholding in such cases. Voluntary withholding was unavailable under prior law in such cases even though the payments were made by an employer and both the employer and employee agreed to the additional withholding. Moreover, withholding was not authorized in the case of annuities and other nonwage type payments even though withholding was desirable in many cases.

General reasons for change.—The inability of a person to have tax withheld on the remuneration he receives means that he may have a substantial and possibly burdensome final tax payment. This often occurs, for example, in the case of persons receiving retirement income or income from annuities and also in the case of earnings of farm and domestic workers.

Explanation of provision.—The Act provides for payor withholding on payments of pensions and annuities when a recipient requests such withholding. If a recipient requests withholding (or the termination of withholding) on these payments, the payor is required to comply with the request. Such voluntary withholding applies only in the case of pensions or annuities received over more than one year; it does not apply to lump-sum payments. Thus, recipients of Civil Service retirement benefits, and those receiving certain veterans benefits and payments under insurance contracts could request the payor to withhold income tax from these payments.

The Act also authorizes the Secretary of the Treasury to issue regulations which provide rules for withholding on any remuneration for services which is not included in the definition of wages, and for any other type of payment for which the Secretary finds withholding appropriate, in cases where both the employer and employee (or payor

and payee) agree to such withholding. The rules could cover such situations as wages paid to farm and domestic workers or payments of interest and dividends. In these cases the amounts withheld will be those required in the case of wages and the rules applicable to withholding from wages will apply.

Effective date.—Withholding on pensions and annuities is to apply to such payments made after December 31, 1970 to provide payors time to prepare their withholding procedures. Withholding where both payor and payee agree to such withholding is to apply to payments made after June 30, 1970.

BB. MISCELLANEOUS INCOME TAX PROVISIONS

1. Amounts Received Under Insurance Contracts for Certain Living Expenses (sec. 901 of the Act and sec. 123 of the code)

Prior law.—Under prior law, as interpreted by the Internal Revenue Service and by the courts, a person whose residence was damaged or destroyed by fire or other casualty and who had to temporarily find another residence while his home was being repaired was required to treat any insurance payments covering the additional living expenses caused by this situation as taxable income.¹

General reasons for change.—The Congress believed it inappropriate to treat insurance payments of the type described above as "income." In fact, such payments merely reimburse the taxpayer for a real casualty loss; namely, the expenses incurred above the normal living expenses because, for a period of time, he does not have the use of the property. The effect of prior law as interpreted by the Internal Revenue Service and the courts was to cause the insured to have a net loss on a reimbursement (under an additional living expense provision of a homeowner's or renter's insurance policy) equal to the income tax he had to pay on the proceeds of the policy. Moreover, the situations giving rise to these insurance payments are beyond the control of the taxpayer.

Explanation of provision.—The Act provides, in the case of an individual whose principal residence is damaged or destroyed by fire, storm or other casualty, that gross income does not include amounts received under an insurance contract as reimbursement for living expenses incurred for himself and members of his household resulting from the loss of use or occupancy of the residence.² However, this exclusion is limited to the excess of actual living expenses incurred by the taxpayer and members of his household over the normal living expenses which they would have incurred during this period.

The additional living expense insurance coverage is intended to reimburse the insured for certain excess living expenses incurred during a period in which his residence may not be used. Generally, these expenses include the additional costs actually incurred for renting suitable housing and extraordinary expenses for transportation,

¹ In 1959, in Rev. Rul. 59-360 (1959-2 C.B. 75), the Internal Revenue Service ruled that insurance payments for additional living costs were not reimbursements for the loss of property but rather constituted income within the meaning of section 61 of the Code. Also, the Tax Court (in *I. Hal Millsap, Jr.*, 46 T.C. 751, 762 (1966) *aff'd*, 387 F.2d 420 (8th Cir. 1968)) held that additional living expenses are not deductible as a casualty loss under section 165 and that reimbursements for these expenses must be included in the taxpayer's income.

² This provision also covers the person who is denied access to his principal residence by governmental authorities because of the occurrence or threat of occurrence of such a casualty.

food, utilities, and miscellaneous services. However, the exclusion is limited to reasonable expenses in excess of normal living expenses which, for purposes of this provision, include only those required to maintain the insured and his household in the same standard of living that they enjoyed before the loss occurred.

Effective date.—These amendments apply to amounts received on or after January 1, 1969.

Revenue effect.—It is estimated that the revenue loss from the provision will be negligible.

2. Deductibility of Treble Damage Payments, Fines, Penalties, etc. (sec. 902 of the Act and sec. 162 of the code)

Prior law.—Under prior law there was no general statutory provision setting forth a “public policy” basis for denying deductions claimed as “ordinary and necessary” business deductions. Nevertheless, a number of business expenses were disallowed on the ground that the allowance of these deductions would be contrary to Federal or State “public policy.” This was true, for example, in the case of fines. One question which arose in this regard is whether deductions should be allowed for damages paid to a private party in a cause of action in which the successful party is entitled to damages in a greater amount than the economic loss demonstrated by him. Under section 4 of the Clayton Act, for example, a person injured by an antitrust violation may sue for damages and recover three times the amount of economic loss established. The Internal Revenue Service (Rev. Rul. 64-224 (1964)) held that amounts paid or incurred in satisfaction of treble damage claims under that act are fully deductible as ordinary and necessary businesses expenses.

General reasons for change.—The question as to whether antitrust treble damage payments should be deductible must be viewed both from the standpoint of antitrust policy and from the standpoint of tax policy. From the standpoint of antitrust policy, the basic issues are the extent of the penalties intended and whether their impact should be reduced by permitting them to reduce taxes which otherwise would have to be paid.

From the standpoint of tax policy, there generally has been a reluctance to deny business expenses on the ground that this departs from the concept of a tax imposed on actual net business income. There still remains, however, the question as to what is an ordinary and necessary business expense. The Supreme Court in the *Tank Truck Rental* case, for example, in holding that the payment of fines could not be considered as ordinary and necessary, stated:

A finding of “necessity” cannot be made however, if allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.

On the same grounds, it appears appropriate to deny deductions for bribes, illegal kickbacks, and the penalty portion of antitrust treble damage payments. A 1958 amendment to the Internal Revenue Code already suggests such a congressional policy. Under that amendment no deduction may be taken for payments to officials or employees of a foreign government if in the United States such payments would be

unlawful. In addition, deduction of expenditures made to influence legislation are already limited by a specific provision (sec. 162(e)) added by the Revenue Act of 1962.

Explanation of provision.—The provision added by the Act denies deductions for four types of expenditures: fines or similar penalties paid to a government for the violation of any law, a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of guilty or nolo contendere), deductions for bribes paid to public officials (whether or not foreign officials), and other unlawful bribes or “kickbacks.” The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions. However, this is not, of course, intended to affect the treatment of lobbying expenditures which are already covered by the tax law.

First, the amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violation of any law. This provision applies in any case in which the taxpayer is required to pay a fine because he is convicted of a crime (felony or misdemeanor) in a full criminal proceeding in an appropriate court. This represents a codification of the general court position in this respect.

Second, it is provided that if a taxpayer is convicted in a criminal proceeding for the violation of the Federal antitrust laws (or pleads guilty or nolo contendere), then no deduction is to be allowed for two-thirds of any amount paid on any judgment for damages against the taxpayer or for settlement of any action brought under section 4 of the Clayton Antitrust Act.

The deduction is denied in these cases (as well as in the case of bribes and kickbacks described below) only where there has been a criminal conviction (or a plea of guilty or nolo contendere) in a related case. This means that the deduction is denied only in the case of “hard-core violations” where intent has been clearly proved in a criminal proceeding. The denial of the deduction is limited to two-thirds of the amount paid or incurred since this represents the “penal” portion of the payment. The remaining one-third continues to be deductible on the grounds that it represents a restoration of the amount already owing to the other party.

The third category for which deductions are denied is illegal payments to government officials and employees. Prior law (sec. 162(c)) disallowed deductions for bribes to foreign officials if the making of the payment would be unlawful under United States laws if those laws were applicable. While it has generally been presumed that deductions were not available for illegal payments to U.S. officials, this was not specified in prior law. In the case of illegal payments to government officials the Congress believed that the offense is sufficiently contrary to public policy as not to require the denial of the deduction to be preceded by the criminal conviction. The provision also applies, as did prior law, to officials or employees of a foreign government. In this case, as under prior law, the test is whether the payment would be unlawful under U.S. laws, were U.S. laws applicable to the payment. The burden of proof in this case as to whether a payment constitutes an illegal bribe or kickback is upon the Treasury Department to the same

extent as if the issue related to fraud—that is, to prove the illegality by clear and convincing evidence.

The fourth category for which deductions are not available are illegal bribes or kickbacks to other than government officials and employees. In this case (as in the case of treble damage payments under the antitrust laws) the deduction is not denied unless in a criminal proceeding a taxpayer is convicted of an illegal bribe or kickback (or enters a plea of guilty or *nolo contendere*). The deduction in this case also is denied for any payments which are related to the illegal bribe or kickback prior to the date of the final judgment or the entering of the plea. The statute of limitations in this case is extended so that, in any case, where indictment was returned (or information filed) prior to the expiration of the statutory period for assessment, the period for the assessment of the deficiency with respect to the disallowance of a deduction is not to expire until one year after the final decision in the criminal action.

Effective date.—The new provisions added with respect to fines and similar penalties and those relating to bribes and kickbacks to government officials are applicable to all taxable years to which the 1954 code applies. The denial of the deduction in the case of certain violations of the antitrust laws applies with regard to amounts paid or incurred after December 31, 1969. However, in this case the provision is not to apply with respect to any conviction or plea before January 1, 1970, or to any conviction or plea on or after that date in a new trial following an appeal of a conviction before that date. The provision relating to illegal bribes and kickbacks to other than government officials applies with respect to payments made after the date of enactment (December 30, 1969).

Revenue estimate.—The revenue effect of this provision is uncertain.

3. Deductibility of Accrued Vacation Pay (sec. 903 of the Act and sec. 97 of the Technical Amendments Act of 1958)

Prior law.—Taxpayers on the accrual basis with two exceptions deduct vacation pay in the year of accrual. Vacation pay is considered to be accrual only after (1) liability to a specific person has been clearly established; (2) the amount of liability can be computed with reasonable accuracy; and (3) the accrued amount will not be forfeited by termination of employment or other cause. A taxpayer may not change his method of handling vacation pay without first obtaining the Treasury Department's approval, since such a change would constitute a change of accounting method.

One of the exceptions to the requirement that taxpayers on the accrual basis must deduct vacation pay in the year of accrual relates to those who since 1949 have consistently accrued and deducted vacation pay in the year in which it was paid. They must continue this practice until they have a vested plan.

The second exception to the requirement that taxpayers must deduct vacation pay in the year in which it accrues relates to those cases where taxpayers have consistently been deducting vacation pay in the year in which the employee completes his qualifying services. To be eligible for this exception, the taxpayer must have been following this practice since 1955. This exception, however, was not available for taxable years ending after 1968.

General reasons for change.—Under the 1939 Code, the period of time for taking deductions with respect to vacation pay was when these expenses were paid or accrued or paid or incurred depending upon the method of accounting, “unless in order to clearly reflect income the deductions should be taken as of a different period.” Under this latter provision, it was held that vacation pay for the next year could be accrued as of the close of the year in which qualifying services were rendered, provided all of the events necessary to fix the liability of the taxpayer for the vacation pay under the employment contract have occurred by the close of the current year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred the fact that the employee’s rights to a vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ended before the scheduled period was not regarded as making the liability a contingent one instead of a fixed one. It was held that the liability was not contingent since the employer could expect the employees as a group to receive the vacation pay; only the specific amount of the liability with respect to individuals remained uncertain at the close of the year.¹

In 1954, Congress enacted a provision, section 462, which provided for the deduction of additions to reserves for certain estimated expenses. Reserves for vacation pay, including accrual on a completion of qualifying service basis, would have been deductible under this provision and it would no longer have been necessary to maintain the administrative position described above with respect to vacation pay. As a result, in Revenue Ruling 54-608 (C.B. 1954-2, 8), the Internal Revenue Service revised its position on the deductibility of vacation pay. In this ruling, it held that no accrual of vacation pay could occur until the fact of liability with respect to specific employees was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. It was thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rule set forth in this ruling would utilize section 462. This ruling was initially made applicable to taxable years ending on or after June 30, 1955.

Because section 462 was later repealed, the Treasury Department in a series of actions postponed the effective date of Revenue Ruling 54-608 until January 1, 1959.² These actions rendered Revenue Ruling 54-608 inapplicable to taxable years ending before January 1, 1959.

Congress, in the Technical Amendments Act of 1958 (sec. 97), further postponed the effective date of Revenue Ruling 54-608 for two more years, making it inapplicable to taxable years ending before January 1, 1961. Subsequently, Congress in four actions (P.L. 86-496, P.L. 88-153, P.L. 88-554, and P.L. 89-692) further postponed the effective date of Revenue Ruling 54-608. The fourth of these laws postponed the application of the ruling until January 1, 1969.

The application of Revenue Ruling 54-608 results in the denial of a deduction in a year where the accrual of vacation pay has not been clearly fixed with respect to specific employees. However, taxpayers who have been accruing vacation pay under plans which do not meet

¹ GCM 25261, C.B. 1947-2, 44; I.T. 3956, C.B. 1949-1, 78.

² The last of these postponements was made in Revenue Ruling 57-325, C.B. 1957-2, 302, July 8, 1957.

the requirements of the strict accrual rules set forth in this ruling, if this ruling were to go into effect, would have one year in which they receive no deduction for vacation pay. This would occur since the current year's vacation pay deductions would have been accrued in the prior year and the next year's vacation pay does not meet the tests of accrual of this ruling. Congress has asked that this problem be studied and that permanent legislation be prepared. For this an additional period of time is needed.

Explanation of provision.—For reasons discussed above, the Act postpones for two more years the effective date of Revenue Ruling 54-608. As a result, deductions for accrued vacation pay, if computed by an accounting method consistently followed by the taxpayer, will not be denied for any taxable year ending before January 1, 1971, solely because the liability to a specific person for vacation pay is not being clearly estimated or because the amount of the liability to each individual cannot be computed with reasonable accuracy if the employee has performed the necessary qualifying services.

Revenue effect.—Since the provision merely extends present rules for two additional years, there will be no revenue changes from the provision.

4. Deduction of Recoveries of Antitrust Damages, Etc. (sec. 904 of the Act and sec. 186 of the code)

Prior law.—Taxpayers often recover substantial damages due to a patent infringement, a breach of fiduciary duty, or an antitrust injury to which section 4 of the Clayton Act applies. Sometimes these recoveries occur many years after the injury was sustained and are includible in taxable income at this subsequent time when actually received.

General reasons for the change.—Difficulty arises from the fact that the original losses may have resulted in no income tax benefit because, due to insufficient income from other sources, the net operating loss carryovers expired before it was possible to offset them against other income. As a result, in some cases taxpayers were required to include damages in income although the losses which they replaced had not resulted in a tax benefit.

Explanation of provision.—The Act provides that, in the case of losses resulting from a patent infringement, a breach of fiduciary duty, or antitrust injury for which there is a recovery under section 4 of the Clayton Act, a special deduction is to be allowed which has the effect of reducing the amounts required to be included in income to the extent that the losses to which they relate did not give rise to a tax benefit.

This is accomplished under the Act by providing that when a "compensatory amount" is received or accrued during a year for a "compensable injury," a deduction is allowed for the "compensatory amount" or, if smaller, the unrecovered losses sustained as a result of the "compensable injury." Compensable injuries are those sustained as a result of a patent infringement, a breach of contract or a breach of fiduciary duty or an antitrust injury for which there is a recovery under section 4 of the Clayton Act.

The unrecovered losses are the net operating losses (whether or not the right to use such losses has expired) attributable to the compensatory injury reduced by those allowed as a deduction as a

loss carryback or carryover. These net operating losses are also reduced by the amount (if any) of a recovery of a compensatory amount in any other years against which these losses were offset.

The second limitation on the deduction is the "compensatory amount." This is the amount received as damages either as an award in or settlement of a civil action for recovery of a compensable injury. This is to be reduced by the expenses in securing the award or settlement. The provision, of course, applies only to recoveries for actual injury and not for any additional amounts.

Effective date.—The provision applies to compensatory amounts received in taxable years beginning after December 31, 1968.

Revenue effect.—It is estimated that the revenue effect of this provision will not be substantial.

5. Corporations Using Appreciated Property to Redeem Their Own Stock (sec. 905 of the Act and sec. 311 of the code)

Prior law.—Prior law (sec. 311 of the code) provided, in general, that gain or loss was not recognized to a corporation if it distributed property with respect to its stock.

General reasons for change.—Recently, large corporations have redeemed very substantial amounts of their own stock with appreciated property and in this manner have disposed of appreciated property for a corporate purpose to much the same effect as if the property had been sold and the stock had been redeemed with the proceeds of the sale. The appreciation was not taxed however, on this type of disposition.

The Congress does not believe that a corporation should be permitted to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of the property in this manner.

Explanation of provision.—The Act provides that if a corporation distributes property to a shareholder in redemption of part or all of his stock and the property has appreciated in value in the hands of the distributing corporation (i.e. the fair market value of the property exceeds its adjusted basis), then gain is to be recognized to the distributing corporation to the extent of the appreciation. This provision applies to any redemption of a shareholder's stock whether or not the redemption is classified as a dividend. On the other hand, the provision does not apply to a complete or partial liquidation of a corporation (i.e., where there is a termination or a contraction of a (Secs. 355 and 356 of the code).

The Act provides certain exceptions and transitional rules. These include the following:

(1) The provision is inapplicable to distributions in complete termination of the interest of a shareholder owning at least 10 percent of the stock, distributions of stock of a 50 percent or more owned subsidiary, distributions pursuant to an antitrust decree, redemptions under section 303 of the code, certain redemption distributions to private foundations, and distributions by regulated investment companies. In addition, in certain very limited cases the provision is inapplicable to the distribution (before December 1974) of the stock of certain subsidiaries which own only assets secured from the parent or another related corporation.

(2) The transitional rules make the provision inapplicable to contracts in existence on November 30, 1969, and written offers which

were made before December 1, 1969, or are made pursuant to a ruling request filed with the Internal Revenue Service or a registration statement filed with the Securities and Exchange Commission before that date. Such offers must not be revocable by their express terms.

Effective date.—This provision applies with respect to distributions after November 30, 1969 in taxable years ending after that date.

Revenue effect.—This provision will prevent the loss of substantial revenue which would occur in the future if there were to be a substantial expansion of the practice of redeeming stock with appreciated property.

6. Reasonable Accumulations by Corporations (sec. 906 of the Act and sec. 537 of the code)

Prior law.—The law imposes a special tax on accumulated earnings of a corporation when the earnings are accumulated to save the individual shareholders from the tax on dividends which would have been incurred by them if the earnings had been distributed. A corporation is not subject to this tax, however, to the extent the earnings were accumulated to meet the reasonable needs of the business, including the reasonably anticipated needs of the business.

The law (sec. 303) also provides that a redemption by a corporation of stock included in the estate of a deceased shareholder is not treated as a dividend to the extent the amount used in the redemption is no greater than the death taxes plus the funeral and administration expenses. This provision applies, however, only if the stock of the corporation in question is more than 35 percent of the gross estate or more than 50 percent of the taxable estate. (The section is also applicable in certain cases when the percentage requirements are met by the stock of two or more corporations and the decedent's estate owns more than 75 percent of the stock of each corporation.)

In addition, the Act elsewhere adds a provision to the effect that a private foundation must dispose of all the stock it owns in excess of "permitted holdings." In general, in the case of foundations which now own substantial amounts of stock in a corporation, "permitted holdings" are defined as 50 percent (but no more than the percentage owned on May 26, 1969) of the stock reduced by the percentage of stock owned by "disqualified persons" (that is, related parties). In addition, the Act provides that although generally there can be no dealing between the foundation and a corporation in which related parties have substantial interests, over a transition period stock can be redeemed in the type of case described above without this being classified as prohibited self-dealing.

General reasons for change.—Where there is a redemption of a large block of stock from a shareholder (whether or not to pay death taxes) the question arises as to whether the money accumulated to pay for the stock redeemed was accumulated for the reasonable needs of the corporation's business. If it was not accumulated for these needs, the corporation becomes subject to the accumulated earnings tax (sec. 531).

It would appear that the same situation will arise when a corporation redeems a large block of stock from a foundation in order to enable the foundation to bring its holdings down to the amount permitted by the Act.

The Internal Revenue Service sometimes has taken the position that any large redemption of stock indicates that the corporation had funds

available for noncorporate purposes and therefore this is evidence that earnings were accumulated beyond the reasonable needs of the business. The courts have decided this issue in favor of the Service in a number of cases.

The Congress concluded that amounts accumulated in the year of the death and later years to redeem stock in a redemption to pay death taxes (sec. 303), as well as amounts accumulated to redeem stock which constitutes an excess business holding in the hands of a foundation should not be considered unreasonable accumulations. To consider them as such would substantially interfere with the purpose of these two redemption provisions.

Explanation of provision.—The Act provides that the reasonable needs of the business (sec. 537) are to include amounts needed (or reasonably anticipated to be needed) in the year of death and later years to redeem stock to pay death taxes and funeral and administration expenses (sec. 303). The Act also provides that the reasonable needs of the business include the amounts needed (or reasonably anticipated to be needed) to redeem from private foundations stock held on May 26, 1969 (or received pursuant to a will or irrevocable trust treated as binding on May 26, 1969) which constitutes an excess business holding.

In addition, the Act provides that in determining whether an accumulation is in excess of the reasonable needs of the business for a particular year, no inference is to be drawn to the effect that funds were not reasonably required in the business from the fact that either of the two special exceptions described above applies in a subsequent year and the accumulated funds are used for such a redemption. In other words, any determination of the reasonableness of an accumulation is to be made without considering that the funds were subsequently used for either of these types of redemptions.

Effective date.—The provisions apply to the tax on accumulated earnings with respect to taxable years ending after May 26, 1969.

Revenue effect.—It is estimated that the revenue effect of these provisions will be negligible.

7. Special Contingency Reserves of Insurance Companies (sec. 907(a) of the Act and secs. 805(e)(4) and 810(c) of the code)

Prior law.—Amounts set aside by a life insurance company in policyholder reserves are deductible in computing the income of the insurance company which is subject to tax. The amounts which are deductible in this regard include not only additions to life insurance reserves, but also, among other things, interest paid on indebtedness and amounts in the nature of interest. Prior law also specifically included in these deductible amounts, interest on special contingency reserves established under the Federal Employees Group Life Insurance Act of 1954.

General reasons for change.—The question which arose is whether deductions for interest paid on indebtedness and amounts in the nature of interest include interest paid on so-called special contingency reserves under group life and group accident and health insurance contracts. One type of these reserves is used to fund over the employee's working life the cost of providing him group term life and group health and accident insurance after retirement. The second type of reserve is used for premium stabilization purposes, that is, to meet unusually large current claims which would otherwise require an increase in premium payments by employers for the insurance cov-

erage provided for employees. In some cases, the reserve is a combination of both types.

When this matter was considered in connection with the Life Insurance Company Income Tax Act of 1959, the Finance Committee Report, the floor manager's statement on the finance committee amendments, and the floor manager's explanation of the conference committee action all contained language based upon the assumption that special contingency reserves in general were covered by the deduction for interest paid on indebtedness, and amounts in the nature of interest, and that the specific reference to contingency reserves on Federal employees group life insurance was adopted merely to "make it clear" that a deduction was available to insurance companies for interest credited on this type of special contingency reserve. Moreover, these special contingency reserves are of the same nature as other reserves held for policyholders, the interest on and additions to which are deductible in arriving at the amount of income of the life insurance company subject to tax. There appears to be no reason for a difference in tax treatment for these special contingency reserves. Despite the congressional intent, the Internal Revenue Service does not feel that it can so interpret prior law. A recent court case, however, upheld congressional intent on this matter.

Explanation of provision.—The Act revises prior law (sec. 805(e) (4) relating to interest on special contingency reserves under FEGLI contracts) to make this provision applicable to interest credited to any special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination of these two purposes. Thus, in computing the amount of their income subject to tax, life insurance companies may deduct interest credited to these types of special contingency reserves whether the reserves are established under FEGLI contracts, private employer contracts, or under other contracts with the Federal Government, such as the Servicemen's Group Life Insurance contract or the Federal Employees Health Benefits Act contract.

The Act also makes comparable changes under the phase II tax imposed on life insurance companies (i.e., the tax on gains from operations other than investment income).

Effective date.—Since the amendments made by this provision are declaratory of what Congress intended in present law, it is provided that the amendments are applicable as of the effective date of the Life Insurance Company Income Tax Act of 1959; namely, taxable years beginning after December 31, 1957.

8. Spinoffs by Life Insurance Company (sec. 907(b) of the Act and sec. 815 of the code)

Prior law.—The Life Insurance Company Income Tax Act of 1959, in general, provides that a life insurance company is taxable currently on its taxable investment income plus 50 percent of its remaining gain from operations. The other 50 percent of its gain from operations is taxed to the company only when, and if, this amount is distributed to shareholders.

Under the Life Insurance Company Tax Act, the portions of the insurance company's income taxed currently are placed in a "shareholders surplus account," which is treated as the first amount distributed to

shareholders. The portion of the life insurance company's gain from operations not taxed currently is placed in a "policyholders surplus account." Distributions from this account are considered as being made only when distributions to shareholders are in excess of the amount in the shareholders account, and distributions out of this policyholder account give rise to the so-called phase III tax on life insurance companies: that is, the deferred tax becomes due when the amounts are distributed to the shareholders. Included in the distributions which may give rise to this tax are distributions in redemption of stock, distributions in partial liquidation and a distribution in a "spinoff" (a distribution of a subsidiary's stock to the shareholders of the life insurance company) which is tax free to the shareholders receiving the stock.

General reasons for change.—In the past, three exceptions have been made to the rule that there would be phase III tax consequences in the case of a spinoff to shareholders of the stock of a subsidiary of the life insurance company: The spinoff of stock of a controlled fire and casualty insurance subsidiary company, if acquired before January 1, 1963, in a tax-free stock-for-stock reorganization; the spinoff of stock of a controlled fire and casualty insurance company subsidiary, without regard to the type of corporate reorganization in which the parent gained control of the subsidiary company, where the parent owned 80 percent or more of the stock of the subsidiary before January 1, 1958 (the effective date of the Life Insurance Company Income Tax Act of 1959); and the spinoff of the stock of a subsidiary corporation which is also a life insurance company, if the spinoff is to a holding company which owns at least 80 percent of the stock of the "first tier" life insurance company subsidiary which, in turn, owns (and has owned since December 31, 1957) at least 80 percent of the stock of the "second tier" life insurance company. The absence of the phase III tax in the case of these three exceptions, however, only applies to the extent there were no contributions to the capital of the second tier company after December 31, 1957 (the effective date of the 1959 Act).

Another case was called to the attention of Congress which differs from the third situation described above only in that the second tier subsidiary is an ordinary corporation subject to the general corporate tax provisions rather than a life insurance company. In this situation the life insurance company wants to spin off the stock of the ordinary business subsidiary to the parent holding company in order to simplify the operations of the group of corporations along functional lines. Moreover, certain States are considering legislation directed against continuing ownership by life insurance companies of noninsurance business interests.

The removal of any assets from the possible application of the phase III tax (as would happen if the regular corporation could be spun off without any tax consequences) does lessen the certainty of the ultimate payment of the phase III tax by the life insurance company. This is particularly important where it is other than a life insurance company which is being spun off, since in such cases the assets cannot be expected to be held for use in an insurance company and could generally be sold or distributed to shareholders without the application of a phase III tax.

Explanation of provision.—The Act permits the spinoff of a second tier ordinary business subsidiary to the parent holding company with-

out the application of phase III tax consequences at that time, but in a manner designed to preserve the potential application of a phase III tax.

To accomplish this result, the Act provides that the phase III tax continues to apply in such a case to the full extent, and in the same manner, as if the spinoff had not been made and as if the distributions to the parent holding company were therefore channeled to it through the life insurance company. As a result, any distributions made by the ordinary business subsidiary will be treated as reducing the shareholders surplus account or the policyholders surplus account (as the case may be) of the life insurance company to the full extent of the distribution and thus give rise to a phase III tax in all cases in which a distribution by the life insurance company would give rise to a phase III tax. The sale (or other disposition) of the stock of the ordinary business subsidiary by the parent holding company also will be treated as reducing the shareholders surplus account or policyholders surplus account of the life insurance company. These effects are limited to the amount of the fair market value of the stock of the ordinary business corporation at the time of the spinoff.

This provision applies in cases where a life insurance company, which at all times since December 31, 1957, has owned all the stock of a business subsidiary, distributes the stock to a parent company which immediately after the distribution owns all the stock of both the life insurance company and the business subsidiary. In such a case, a distribution to the parent holding company of the stock of the business subsidiary by the life insurance company which is tax-free (under sec. 355) does not reduce the life insurance company's shareholders or policyholders surplus accounts and thus give rise to phase III tax consequences, except to the extent of its post-1957 contributions to capital of the business subsidiary.

The provision further provides, however, that subsequent distributions by the spunoff subsidiary to the parent holding company will result in reductions in the shareholders surplus account or policyholders surplus account (as the case may be) of the life insurance company in the same manner and to the same extent as if the distribution had been made by the life insurance company itself until the amounts so distributed by the spunoff subsidiary (plus any amounts treated as a distribution in the spinoff) equal the fair market value of the stock at the time of the spinoff. The same treatment also is accorded any dispositions of stock of the spunoff subsidiary by the parent holding company.

Effective date.—This amendment applies to taxable years beginning after December 31, 1968.

9. Loss Carryover of Insurance Company on Change of Form of Organization or Nature of Insurance Business (sec. 907(c) of the Act and sec. 844 of the code)

Prior law.—The rules governing the income tax treatment of insurance companies differ somewhat depending on the form of the companies' organization (stock or mutual) and the nature of the companies' insurance business (life, casualty, etc.). An insurance company which incurs losses during periods when it is subject to tax under one set of rules, in the past, has not been able to carry these losses forward and deduct them (as it could if its status had not changed) during periods in which the company is subject to tax in a different status.

General reasons for change.—The limitation on the use of losses by insurance companies has been provided in the past primarily because a loss of one type of organization carried over to a period when it is taxed as another type might result in too generous treatment. (For instance, until 1962 mutual casualty companies were not taxed on their underwriting income and their underwriting losses were not taken into account for Federal tax purposes.) There appears to be no reason for this, however, if a company in changing its form of organization or the nature of its insurance business does not receive more favorable operating loss carryforwards than it would receive in the case of either type of organization.

Explanation of provision.—The Act modifies the previous tax treatment of insurance companies to permit them to take deductions for loss carryovers even though their insurance company tax status changes (such as from a mutual casualty, etc., company to a stock casualty, etc., company or to a life insurance company or vice versa). Subject to one special rule, the provision permits the deduction subject to the normal conditions and limitations which govern loss carryovers generally. This special rule limits the amount of the allowable loss carryover, where an insurance company's tax status has changed, to the lesser of the loss carryover as computed under the rules applicable to the company before the change or the loss carryover as computed under the rules which apply to the company after the change. Where a casualty insurance company changes from a mutual to a stock company, the Act also provides that in computing the loss carryover allowable under the stock company rules, 25 percent of the deduction for dividends paid to policyholders is denied. The provision authorizes the issuance of regulations to prescribe the rules necessary to effect this result.

Effective date.—This provision applies to the carry-forward of losses incurred by insurance companies in taxable years beginning on or after January 1, 1963 (the date on which the casualty insurance company tax provisions were substantially revised), but it does not permit a deduction to be taken under the new rules for any taxable year beginning before January 1, 1967. The fact that a company's tax status changed before 1967 is immaterial if the loss deduction carried over from the prior type of insurance company is not deducted before 1967. This is true, for example, if the change was a result of acquiring, or having been acquired by (in a merger or otherwise), another insurance company in a tax-free reorganization before the effective date of the provision.

10. Mutual Funds Under Periodic Payment Plans (sec. 908 of the Act and sec. 851(f) of the code)

Prior law.—A mutual fund plan sponsor is an underwriter which sponsors a periodic payment plan for the accumulation of mutual fund shares by small investors. Under such a plan each investor makes regular monthly payments to accumulate shares of a specific designated mutual fund. The payments are made to a bank custodian which buys the shares of the issuing fund from the fund and holds them in its own name for the respective accounts of the investors. There are nearly 2 million small investors using these plans.

Under prior law, the Internal Revenue Service treated a group of periodic payment investors subscribing to a particular plan as "an association taxable as a corporation" because the bank serving as cus-

todian was regarded under S.E.C. rules as if it exercised centralized managerial powers for the investors (like the president and board of directors of a corporation).

General reasons for change.—In practice, since the bank custodian can only purchase shares of a single specified mutual fund, it does not exercise managerial discretion but performs ministerial functions in much the same manner as a brokerage office holding securities in its own name for a particular customer. However, treating the plan as a corporation may result in significant adverse treatment of the investors. Thus, if an investor asks for his stock and it is delivered to him individually, gain or loss may be recognizable on this transaction although the investor merely has taken down his own shares.

Explanation of provision.—The Act adds a provision (sec. 851(f)) to the regulated investment company provisions to provide that a periodic payment plan is not to be treated as a corporation, partnership, or trust and that instead the mutual fund shares are to be treated as owned directly by the investor with the bank custodian acting as a nominee.

The new provision does not apply in the case of a unit investment trust (or a management-type of investment company) which is a segregated asset account (described in sec. 801(g) of the code) under the insurance laws or regulations of a State. Where these accounts hold assets pursuant to variable annuity contracts, the account is taxed as part of the life insurance company. In addition, the provision does not apply to other unit investment trusts where the assets are treated as part of the assets of the sponsoring life insurance company for purposes of State insurance laws, but where the assets are not held subject to variable annuity contracts. Under existing law, trusts of this type may be classified as associations taxable separately from the life insurance company and may elect to be taxed as regulated investment companies under subchapter M. It is not intended by this provision to change the tax treatment of these trusts taxed as associations. In other words, this type of unit investment trust will continue to be taxed as an association and there is no change in the treatment of distributions in redemption of interests in it.

Effective date.—The provision applies to taxable years of unit investment trusts ending after December 31, 1968, and to taxable years of holders of interests in these trusts ending with or within the taxable years of such trust.

Revenue effect.—The amendments made by this provision are expected to have a negligible effect on revenues.

11. Foreign Base Company Income (sec. 909 of the Act and sec. 954(b)(4) of the code)

Prior law.—U.S. shareholders of a controlled foreign corporation are taxed currently on certain income earned abroad by the corporation, including what is termed "foreign base company income." Foreign base company income includes foreign personal holding company income, foreign base company sales income (generally income from the sale of property produced in the United States or a foreign country by one corporation and sold by a related corporation organized in another country for use outside that country), and foreign base company services income. Basically, this provision is designed to prevent the avoidance of tax by the diversion of sales or other types of income to

a related foreign corporation which is incorporated in a country that imposes little or no tax on this income when it is received by that corporation since it arose in connection with an activity taking place outside of that country.

Prior law provided an exception from this provision for an item of income where it was established to the satisfaction of the Secretary of the Treasury or his delegate that the creation or organization of the controlled foreign corporation in the foreign country in which it was incorporated did not have the effect of a substantial reduction of income or similar taxes with respect to that income.

General reasons for change.—Cases have come to the attention of Congress where controlled foreign corporations have substantial investments in the foreign country in which they are organized which they must dispose of because of the laws of the foreign country relative to permissible investments of foreigners. If that foreign country imposes little or no capital gains tax, then the exception in prior law was not available with respect to the gain on the sale of the investments since there was a reduction of income taxes (relative to the tax which would have been paid in the United States were the transaction to occur here). This was true even though the corporation was not organized to reduce taxes and the purpose of the sale was to comply with foreign laws and not to reduce taxes.

These cases led to the reexamination of the exception contained in prior law which focused only on the question of whether there was a reduction of taxes. It appeared more appropriate for the availability of the exception to depend on whether the controlled foreign corporation was established in a given foreign country, and the transaction giving rise to the income was effected through that corporation, for the purpose of reducing income taxes.

Explanation of provision.—The Act provides an exception from foreign base company income treatment to the effect that a controlled foreign corporation's foreign base company income does not include any item of income received by the corporation if two factors are established to the satisfaction of the Secretary of the Treasury or his delegate.

First, it must be established that the creation or organization of the corporation under the laws of the particular foreign country did not have as one of its significant purposes a substantial reduction of income or similar taxes. If the taxpayer acquired a corporation which had previously been organized in a particular foreign country, then it must be established that the acquisition of a corporation created in that particular foreign country did not have as one of its significant purposes a substantial reduction of income or similar taxes.

Generally, if the income-producing activity carried on by a foreign corporation takes place within the country in which it is created or organized, it will not be considered as having been established in that country to achieve a substantial reduction in income taxes. This includes, for example, a corporation engaged in a manufacturing operation within its country of incorporation. If it is determined that one of the significant purposes of creating or organizing a foreign corporation in a particular country was to achieve a substantial reduction of income taxes, then none of the income received by that corporation could qualify under the exception from foreign base company income provided by the Act.

Second, in addition to establishing that a substantial reduction of income taxes was not one of the significant purposes for creating the foreign corporation within a particular country, the taxpayer must also establish that the effecting of the transaction which gives rise to the income in question through that foreign corporation does not have as one of its significant purposes a substantial reduction of income taxes. For example, a foreign corporation engaged in a manufacturing operation within its country of incorporation normally would meet the first test described above. However, if that corporation also derived other types of income and one of the principal purposes of having the corporation receive that income was to achieve a substantial reduction of the income taxes imposed on the income, then the second test is not met and the exception from foreign base company income treatment does not apply.

The exception from foreign base company income treatment is available with respect to all three classes of foreign base company income: that is, foreign personal holding company income, foreign base company sales income and foreign base company services income. Where a controlled foreign corporation receives an item of foreign base company income and it is believed the exception is applicable with respect to the income, as already provided under prior law, the U.S. shareholder of the corporation would indicate in the return filed with respect to the corporation (attached to his return) the amount of income involved and the reasons why he believes the exception is applicable.

The application of the exception from foreign base company income provided by the Act may be illustrated by the following example. A controlled foreign corporation is incorporated under the laws of a foreign country. In the past the controlled foreign corporation has organized a number of other corporations in that country to operate radio and television stations there. The purpose of establishing these other corporations was to form a centrally managed radio and television network. The controlled foreign corporation's stock interest in these other corporations ranges from 10 percent to 100 percent. By reason of its stock interests and for other financial or technical reasons, the controlled foreign corporation has exercised effective practical control over the other corporations. The controlled foreign corporation also has conducted several businesses in the foreign country for a number of years which are related to the communications network it was attempting to establish.

In 1969, the communications agency of the foreign country changes its policy and rules that foreign corporations may not own more than 10 percent of the stock of local communications corporations. Since the controlled foreign corporation is more than 50 percent owned by U.S. persons, it is treated by the communications agency of the foreign country as being subject to this new rule. Because of this policy change, the controlled foreign corporation sells all its shares of stock in the radio and television corporations in the foreign country and realizes capital gains on the sales which, however, are not taxed by the foreign country.

Under the exception from base company income treatment provided by the Act, these gains are not treated as foreign base company income. This is because the controlled foreign corporation was organized in the foreign country to actively engage in business in that country and

because the acquisition and the sale of the stock of the radio and television corporations by the controlled foreign corporation (rather than by its parent corporation or an affiliated corporation) did not have as one of its significant purposes the reduction of income or similar taxes.

Effective date.—This provision applies to taxable years ending after October 9, 1969.

12. Deferral of Gain Upon the Sale of Certain Low-Income Housing Projects (sec. 910 of the Act and sec. 1039 of the code)

Prior law.—Where an individual sells his personal residence and reinvests the proceeds from this sale within a certain specified time in another personal residence, no gain is recognized on the sale of the first residence to the extent the proceeds are so reinvested. Instead, the basis of the second residence is reduced by the amount of gain not recognized with respect to the first residence, with the result that if the second residence is resold without the funds being reinvested in a third residence, the gain is generally realized at that time. The Code also provides for the nonrecognition of gain on a similar basis in the case of involuntary conversions of property and also in the case of "like-kind" exchanges. No deferral of the recognition of gain is available, however, under present law in the case of the sale of lower income housing held as rental property.

General reasons for change.—In the case of federally assisted housing projects (where the return to the investor is limited to approximately 6 percent), the Government is interested in encouraging the sale of these Government-assisted housing projects to the low- or middle-income occupant or to a nonprofit organization which manages the property on their behalf (such as cooperatives). The maximum sales price permitted under these programs under present law is the amount the individual has invested in the property, an amount necessary to retire the outstanding mortgage liability, and the taxes payable as a result of the sale. By providing that no gain is to be recognized in these cases, it would be possible to decrease the sales price to the occupants or tax-exempt organizations managing these properties. This should enable them to make purchases they otherwise could not make.

Explanation of provision.—The Act permits a taxpayer who invests in a federally assisted lower income housing project (so-called FHA 221(d)(3) and 236 projects) to sell the property and pay no current tax on the gain involved where (1) he sells the property to the occupants or to a nonprofit organization which manages the property, and (2) the full proceeds from the sale are reinvested within a specified period in other federally assisted low-income housing projects which limit the investor's rate of return. In these cases, it is provided that no gain is to be recognized on the sale of the first project. The taxpayer's basis from the old property, to the extent the proceeds are reinvested in similar property, is carried forward and become a part (or all) of his basis for the new property.

If only part of the proceeds from the sale of a qualified project is invested in a similarly qualified project, gain on the sale of the old project is to be recognized to the extent of the smaller of: (1) the excess of the proceeds from the sale of the old project over the amount invested in the new project, or (2) the gain realized on the sale of the old project.

The basis of the new project is to be the adjusted basis of the old project to the extent the proceeds from the sale are reinvested, plus any additional funds invested in the new project.

The holding period of the first property is taken into account in determining how long the new property is held, but only with respect to that part of the new property representing the amount of the sale proceeds of the first property which were reinvested in the new project. Any investment in a new project in excess of the sales proceeds of the old project will have a holding period beginning with the acquisition of the new project.

For the treatment described above to apply, the proceeds from the sale of the first property must be reinvested in the second property within a period beginning one year before the sale and ending one year after the close of the first taxable year in which any part of the gain is (or otherwise would be) realized. However, the Secretary or his delegate is given the authority to extend the reinvestment period beyond the latter date pursuant to regulations on application by the taxpayer.

Effective date.—This provision applies with respect to sales made after October 9, 1969.

Revenue effect.—The loss of revenue from this provision is expected to be negligible.

13. Cooperative Per-Unit Retain Allocations Paid in Cash (sec. 911 of the Act and sec. 1382(b) of the code)

Prior law.—Patronage dividends paid in money, qualified allocations, or other property may be paid to the patron within 8½ months after the end of the year in which the earnings to which they relate arise. Where this occurs the cooperative is not taxed, but the patron is taxed on this amount in the following year when he receives the patronage dividend. Patronage dividends are amounts determined by reference to the net earnings of the cooperative from business done with, or for, its patrons.

Per-unit retain allocations, if paid in qualified per-unit retain certificates, also may be paid to the patron within 8½ months after the end of the taxable year, with the cooperative receiving a deduction or exclusion for these amounts in the prior taxable year and the patron reporting these amounts as taxable income. However, this treatment was not available under prior law in the case of per-unit retain allocations paid in money or other property. Per-unit retain allocations are payments to patrons with respect to products marketed for them where the amount is fixed without reference to the net earnings of the organization. Usually the per-unit retain allocation is fixed on the basis of the number of units marketed with the cooperative.

General reasons for change.—Problems arose under prior law where cooperatives desired to make cash payments to patrons with respect to cooperative pools, but could not make them before the end of the year because their accounting records were not closed at that time. These payments could not be made during the 8½ month period as cash patronage dividends because they could not be paid with respect to net earnings. The net earnings of the pool cannot be determined until the pool is closed, which may occur much later. Moreover, under prior law the payments could be made as per-unit retain allocations only if they were paid as qualified per-unit retain certificates. There seems to be no reason why a cooperative should be able to deduct per-unit retain

allocations paid as qualified certificates during the 8½ month period following the close of the taxable year, but not per-unit retain allocations paid in money during the same period.

Explanation of provision.—The Act provides that a cooperative can deduct or exclude from gross income per-unit retain allocations paid during the 8½ month period following the close of the taxable year whether they are paid in money (or other property) or in qualified per-unit retain certificates.

Effective date.—This provision applies to per-unit retain allocations made after October 9, 1969.

14. Inclusion of Foster Children in the Definition of Dependents (Sec. 912 of the Act and sec. 152(b)(2) of the code)

Prior law.—Under prior law, a taxpayer was allowed a personal exemption of \$600 for each dependent, provided that the dependent's gross income did not exceed \$600 per year. An exception to the \$600 gross income rule allowed a taxpayer to claim the \$600 personal exemption for a child (in addition to the child claiming a \$600 personal exemption), if the child had not attained the age of 19 or regardless of age if he were considered to be a full-time student at an educational institution. A "child" was defined as a son, stepson, daughter, or stepdaughter of the taxpayer. Included within this definition was a legally adopted child or a child placed in a taxpayer's household for adoption by an authorized adoption agency.

Since the term "dependent" includes an individual who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer, foster parents could claim a dependency exemption for foster children. However, no exception was provided under prior law to the \$600 gross income rule for dependent foster children (i.e., if the foster child earned more than \$600 for the taxable year, the foster parent could not claim the foster child as a dependent, even though the parent provided more than one-half of the support).

General reasons for change.—The prior law treatment prevented foster parents from claiming the dependency personal exemption for a foster child where the foster child earned more than \$600 gross income during the taxable year, even though they provided the same support (i.e., more than one-half) for their foster child as they did for their natural child. In a recent Tax Court case (*Reed v. Commissioner*) where one natural child and two foster children of the taxpayer were attending college and had earned more than \$600, the court allowed a dependency exemption for the taxpayer's natural child but not for the foster children (even though the taxpayer provided more than one-half of the support for each of the children). The Congress saw no reason for continuing this difference in treatment between foster and natural or adopted children.

Explanation of provision.—The Act amends the code (sec. 152(b)(2)) to permit a taxpayer to take a dependency exemption for a foster child who is less than 19 years of age or is a full-time student regardless of the amount of the child's income, provided the parent furnishes more than one-half of the child's support for the taxable year and the child has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household for the taxable year.¹

¹ Under Treasury Regs. § 1.152-1, the taxpayer and the dependent are considered as being a member of the household for the entire taxable year notwithstanding temporary absences due to illness, education, business, vocation, military service, birth or death during the year, or under a custody agreement under which a child is absent for less than 6 months in the taxable year.

Effective date.—This provision is effective for taxable years beginning after December 31, 1969.

Revenue effect.—The revenue effect of this provision is expected to be small.

15. Cooperative Housing Corporations (sec. 913 of the Act and sec. 216(b) of the code)

Prior law.—A tenant-stockholder of a cooperative housing corporation may deduct from his income his proportionate share of the interest and State and local real estate taxes paid or incurred with respect to a cooperative housing corporation. For a tenant-stockholder to qualify for this deduction under prior law, 80 percent or more of the gross income of the housing cooperative must have been derived from individual tenant-stockholders.

General reasons for change.—It has been pointed out that some of the income of housing cooperatives comes from governmental agencies, which sublease apartments to low- and moderate-income families. In these cases, the individual tenant-stockholders may not be able to meet the 80-percent gross income test, as more than 20 percent may come from a governmental entity. The Congress saw no reason to deny the individual tenant-stockholders these interest and tax deductions merely because a governmental unit held more than a 20-percent income interest in the cooperative housing corporation.

Explanation of provision.—The Act provides that in determining whether a corporation is a cooperative housing corporation, stock owned and apartments leased by governmental entities empowered to acquire shares in a cooperative housing corporation for the purpose of providing housing facilities are not to be taken into account. This will allow individual tenant-stockholders to deduct their proportionate share of interest and real estate taxes even though less than 80 percent of the housing cooperative's gross income is derived from individual tenant-stockholders, if part of the income is from a governmental entity.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

16. Personal Holding Company Dividends (sec. 914 of the Act and sec. 563(b) of the code)

Prior law.—In computing the personal holding company tax under prior law, a taxpayer could elect to take a deduction for dividends paid on or before the fifteenth day of the third month following the close of its taxable year (e.g., on or before March 15 in the case of calendar year corporations). When a distribution was made during this period, it was treated as a dividend distribution made in the prior taxable year. The amount of the deduction which could be taken for these dividends, however, could not exceed 10 percent of the dividends paid by the corporation during the year (computed without regard to this provision).

General reasons for change.—It appeared that it was sometimes difficult for a taxpayer to make accurate estimates of earnings and profits before its books and records were closed for a year for which the corporation wished to take a dividends paid deduction. The 10 percent limit of prior law often did not provide the taxpayer with an adequate margin to avoid paying either too much or too little in dividends during the year to meet the 90 percent requirement. As a result, some tax-

payers found that they were subject to the penalty of the personal holding company tax in those situations where too small a dividend was paid because of their inability to make an accurate estimate of earnings.

Explanation of provision.—The Act raises the 10-percent limit to 20 percent. Thus, in computing the personal holding company tax, a taxpayer may elect to take a deduction for dividends paid on or before the fifteenth day of the third month following the close of its taxable year, provided that the dividend deduction does not exceed 20 percent of the dividends paid by the corporation during the year (computed without regard to this provision). As a result, taxpayers faced with the possibility of a personal holding company tax now have a greater margin in determining the appropriate amount of a dividend distribution which must be made during the year if the penalty tax is to be avoided.

Effective date.—This provision is effective for taxable years beginning after December 31, 1969.

Revenue effect.—The revenue effect of this provision is expected to be negligible.

17. Replacement of Property—Involuntary Conversion Within a 2-Year Period (sec. 915 of the Act and sec. 1033(a)(3)(B) of the code)

Prior law.—No gain is recognized under present law if property is compulsorily or involuntarily converted into property which is similar or related in use or service (called replacement property). To the extent that the net proceeds from an involuntary conversion are not invested in replacement property, gain is recognized to the extent of the proceeds which were not so reinvested, or the gain realized on the involuntarily conversion if smaller. Under prior law the taxpayer had one year after the year in which the involuntary conversion occurred to replace the property, or such longer period as may be allowed by the Internal Revenue Service upon written application.

General reason for change.—The automatic time allowed for replacement was frequently inadequate in situations where Federal agencies or other governmental entities take private property for the development of lakes, airports, highways, or other use.

Explanation of provisions.—The Act extends the automatic period during which tax payers may replace property which has been involuntarily converted to two years.

Effective date.—This change applies with respect to compulsory or involuntary conversions which occur after December 30, 1969.

18. Change in Reporting Income on Installment Basis (sec. 916 of the Act and sec. 453 of the code)

Prior law.—The Internal Revenue Code does not preclude revoking an election by a taxpayer to report income for Federal income tax purposes on the installment basis but it requires Internal Revenue Service consent as a change in method of accounting. However, the Internal Revenue Service has been reluctant to allow revocation of the election since such revocation is not specifically provided for under present law.

General reasons for change.—The Accounting Principles Board of the American Institute of Certified Public Accountants ruled in

1966 that the installment method of recognizing revenue is no longer acceptable for financial reporting purposes except in rare cases. The effect of this opinion is to require accrual reporting for accounting periods beginning after 1966. Taxpayers who elected installment reporting for tax purposes were therefore required to maintain sufficient records to satisfy two methods of reporting. This created unreasonable accounting burdens for many taxpayers. Although in several cases, firms could rectify this situation by reverting from installment reporting to accrual reporting for federal tax purposes, the Internal Revenue Service as indicated above was reluctant to allow this. This resulted in a hardship that could be detrimental to small and medium sized merchandising firms which had previously elected the installment method of reporting.

Explanation of provisions.—The Act modifies the installment reporting provision to allow a taxpayer to retroactively revoke an election to report on the installment basis. For this treatment to be available, the taxpayer must file a notice of revocation within three years following the date of the filing of the tax return for the year the installment method was elected. The revocation applies to the year installment reporting was elected and subsequent years. Interest is not allowed, however, on any refunds or credits resulting from a revocation. This provision applies to any taxable year in which installment reporting was elected if the statute of limitations on the assessment of deficiencies for the year has not expired on the date of passage of the Act.

19. Recognition of Gain in Certain Liquidations (sec. 917 of the Act and sec. 333 of the code)

Prior law.—If the required percentage of shareholders elect to liquidate their corporation under the one-month liquidation rules of section 333 of the code, any gain realized by a shareholder is taxed to him only to the extent of his share of the corporation's earnings and profits, or if greater, to the extent of the amount of money and securities he receives which were acquired by the corporation after 1953. Under prior law for purposes of this rule, securities received by a corporation in a tax-free transfer from a shareholder after 1953 were treated as acquired after 1953 even though the shareholder acquired the securities before 1954.

General reasons for change.—For a limited period of time, it was considered appropriate for purposes of the one-month liquidation rule to treat as acquired by the corporation prior to 1954 securities which it acquired in 1954 and later years pursuant to a tax-free transfer from a person who acquired the securities prior to 1954 if the securities are transferred back to the same person who contributed the securities to the corporation (or someone who received the stock by gift, bequest or inheritance).

Explanation of provisions.—The Act provides that for purposes of the one-month liquidation rule, stock or securities which were transferred to a corporation in a tax-free transfer from persons already controlling the corporation (sec. 351) after December 31, 1953, is to be treated as acquired by the corporation before January 1, 1954, if (1) they were acquired before that date by the person who made the transfer to the corporation, and (2) the corporation transfers the stock or securities back to this same person, or another person who acquired the corporation's stock or securities from the original con-

tributor by gift, bequest or inheritance. The corporation must transfer the same stock or securities, except that stock or securities which are received in a stock split or as a stock dividend is considered to be the same stock.

Effective date.—This change applies only to liquidations occurring during 1970.

CC. MISCELLANEOUS EXCISE TAX PROVISIONS

1. Application of Excise Taxes on Trucks to Concrete Mixers (sec. 931 of the Act and sec. 4063(a) of the code)

Prior law.—Until 1967, the 10-percent excise tax on the manufacture of automobile trucks was not applied in the case of concrete mixer bodies where the actual mixing of the concrete occurred in the tank mounted on a truck chassis. The truck chassis in such a case, however, is subject to the excise tax. In 1967 the Internal Revenue Service reversed its position with respect to concrete mixers mounted on truck chassis. At that time it concluded that these concrete mixers were not designed and adapted by the manufacturer for purposes predominantly other than the transportation of property on the highway.

General reasons for change.—Apparently the change in the Internal Revenue Service's ruling policy stemmed from an exemption for seed, feed, and fertilizer spreaders added by Congress in 1965. In the committee report on that provision reference was made to the fact that these would not be taxable even though incidental highway use occurred. It was not the intent of Congress when it provided an exemption from the excise tax on automobile trucks for these purposes that the language used in connection with the provision for the exemption would result in the review of existing items not subject to tax, and the reclassification of them into a taxable status. Moreover, "incidental" in such a case was not intended to tax equipment where its highway transportation use was functionally incidental or subordinate to some nonhighway use—in this case, the mixing of concrete.

Explanation of provision.—The Act provides an exemption from the manufacturer's excise tax on motor vehicles in the case of articles designed to be mounted on automobile truck, truck trailer, or semi-trailer, chassis which are designed to be used to process or prepare concrete. In addition, an exemption is provided for parts and accessories designed primarily for use on or in connection with these concrete mixers.

Effective date.—This provision applies to articles sold after December 31, 1969.

2. Constructive Sales Price (sec. 932 of the Act and sec. 4216(b) of the code)

Prior law.—Present law (sec. 4216(b), unchanged by the Act except for the addition of the paragraphs described in this section) provides for a constructive sales price (as a substitute for the actual sales price) as a base for the various ad valorem manufacturers' excise taxes in several different types of situations. One of these involves the situation where the article is sold at less than the fair market price if the transaction is not at arm's length. Sales between related companies are examples of sales which are not considered to be at arm's length. As a result, in the case of a sale by a manufacturer or importer to its selling

affiliate, a determination must be made as to whether the sale is at less than "fair market price," and where this is true, the appropriate constructive price must be determined by general standards. If industry data are available, the determination should properly be made by reference to the prices for which others in the same industry at the same level of distribution sell similar articles. Because of difficulties in obtaining what it considers to be adequate information as to selling practices and prices of various companies within an industry, the Internal Revenue Service has generally not made determinations of constructive sales prices by reference to sales by other companies.

In 1962, however, the Internal Revenue Service published a ruling providing for a constructive sales price where a manufacturer or importer (the party liable for the excise tax) sells his products to a wholly owned sales subsidiary and the subsidiary resells to one or more independent wholesale distributors (Rev. Rul. 62-68, 1962-1 C.B. 216). This provided that the taxpayer could elect to treat the constructive sales price as being 95 percent of the lowest price for which the sales subsidiary resold the article to independent or unrelated wholesale distributors. The Service has also ruled privately that where a manufacturer or importer makes sales to a wholly-owned selling subsidiary at a price less than the fair market price, and the wholly-owned selling subsidiary resells the articles to independent retailers but does not regularly sell to wholesale distributors, the constructive sales price is 90 percent of the selling subsidiary's lowest price to independent retailers.

General reasons for change.—In those industries where the pricing policies of competitors on any broad basis are difficult to determine with certainty, the ruling policy of the Internal Revenue Service has been of help. It acknowledges that the price at which the selling company sells, either to wholesalers or to retailers, overstates the price at which the affiliated manufacturer or importer could be expected to sell to the selling company. However, where information as to the selling prices of others in an industry can be obtained, this information may well indicate that where most sales are to retailers, the 10-percent markdown is inadequate.

Explanation of provisions.—The Act adds two constructive price rules to the tax laws dealing with situations where a manufacturer or importer regularly sells an article subject to excise tax to an affiliated corporation and that corporation regularly sells these articles to independent retailers but does not regularly sell to wholesale distributors. The first of these rules is the 90-percent rule described above. The second rule provides a method for determining the fair market price in the case of such sales to a selling affiliate by reference to the markups of others in the same industry who normally sell to independent distributors.

The first rule provides that the fair market price of the article is to be 90 percent of the lowest price for which the affiliated selling corporation regularly sells the article in arm's-length transactions to independent retailers. The second rule provides that where the distributor regularly sells only to retailers and the normal method of sales in the industry is by arm's-length sales to distributors, the fair market price of the article is to be the price at which the article is sold to retailers by the affiliated distributor, reduced by a percentage equal to the markup used by the independent distributors in that industry.

This latter rule, in effect, allows a manufacturer to establish a fair market price on its products with the opportunity for the Service to comment on the adequacy of this determination under the guidelines set forth.

This provision does not attempt to cover all situations where a manufacturer or importer sells to an affiliated company but only to codify and clarify prior law with respect to the more common situations discussed above. In other situations, such as a sale by a wholly-owned manufacturing corporation to its parent corporation which, in turn, regularly resells to independent wholesale distributors, as well as at retail, the fair market price continues to be determined under the existing constructive price provisions.

In computing a sales subsidiary's lowest price to independent parties, this price is determined in the same manner as if the price were in a taxable sale. This price is, for example, the net price to the purchaser after taking into account trade discounts given by the seller as a result of contractual arrangements existing at the time of the sale. Also, it is not required that the sales subsidiary make any given percentage of its sales at a particular price in order for these to be the lowest price so long as the sales are bona fide arm's-length transactions regularly engaged in with unrelated parties. Moreover, where sales are made both including and excluding transportation charges, the lowest price is the price excluding the transportation charge.

Effective dates.—These amendments apply to articles sold after December 31, 1969.

Revenue effect.—It is believed that the revenue effect of these provisions will be negligible.

DD. MISCELLANEOUS ADMINISTRATIVE PROVISIONS

1. Filing Requirement for Individuals (sec. 941 of the Act and sec. 6012(a) of the code)

Prior law.—Under prior law an individual was required to file a tax return if his gross income was \$600 or more unless he was age 65 or over, in which case he was required to file a tax return if his income was \$1,200 or more.

General reasons for change.—With the increases in the minimum standard deduction to \$1,000 and the personal exemption to \$750, the nontaxable level of income for a single person will rise to \$1,750 and for a married couple to \$2,500 when these provisions are fully effective in 1973. As a result, the prior law filing requirements would give rise to a substantial amount of unnecessary filing of returns by those not subject to tax. This would cause an appreciable amount of paper work both for the taxpayers and the Internal Revenue Service.

Explanation of provision.—The Act raises the income level at which a tax return must be filed in tax years 1970, 1971, and 1972 to \$1,700 for a single taxpayer, \$2,300 for a married couple (or a single person age 65 or over), \$2,900 in the case of a married couple where one spouse is age 65 or over and \$3,500 in the case of a married couple where both spouses are age 65 or over. For the tax year 1973 and thereafter these income levels for filing returns are further increased to \$1,750, \$2,500, \$3,250, and \$4,000 respectively to reflect the further increase in the personal exemption to \$750 in that year.

For married couples, these higher filing requirements are applicable only if spouses have the same household as their home at the end of the year. Temporary absences at that time because of circumstances such as business, vacation, or military service will not affect eligibility. They are not applicable if either spouse files a separate return or if any other taxpayer is entitled to an exemption for either spouse. This latter rule is a reflection of the provision which prohibits a taxpayer from claiming an exemption on his return for someone who files a joint return. In these cases and in the case of married individuals filing separate returns the filing requirement remains at \$600 until 1973 when it is increased to \$750.

Effective date.—The changes in the filing requirement for tax years 1970, 1971 and 1972 apply to taxable years beginning after December 31, 1969; the changes for the tax years 1973 and thereafter apply to taxable years beginning after December 31, 1972.

2. Computation of Tax by Internal Revenue Service (secs. 803(d) (1) and 942 of the Act and sec. 6014 of the code)

Prior law.—Under prior law taxpayers could elect to have the Internal Revenue Service compute their tax only if their gross income was less than \$5,000 and they did not claim adjustments for sick pay, moving expenses, etc., or itemize their deductions. Their income must also have consisted of wages subject to withholding and no more than \$200 of dividends, interest and wages not subject to withholding. The tax in these cases was computed from the optional tax tables and did not take account the retirement income credit and whether the taxpayer was a head-of-household or surviving spouse. In addition, for the tax computation, the optional tax table containing the minimum standard deduction was not available to married taxpayers filing separate returns.

General reasons for change.—The Congress concluded that the limitations on the type of taxpayer who may elect to have his tax computed for him by the Internal Revenue Service were unnecessarily restrictive. The liberalization of these restrictions will permit the Internal Revenue Service to extend substantially its program of assistance to taxpayers.

Explanation of provision.—The Act raises the income limit for a taxpayer to elect to have his tax computed by the Internal Revenue Service from \$5,000 to \$10,000. It also provides that the tax computation is to take account of the taxpayer's status as a head-of-household or surviving spouse and the optional tax table which contains the minimum standard deduction is to be available to married taxpayers filing separate returns. In addition, the Secretary of the Treasury by regulation is to outline the conditions under which a taxpayer, in cases other than those described above, may request the Internal Revenue Service to compute his tax. These regulations may provide that the Internal Revenue Service will compute the tax regardless of the source of the taxpayer's gross income, regardless of whether it is \$10,000 or more, regardless of whether the taxpayer itemizes his deductions or takes the standard deduction, and whether or not a retirement income credit is to be taken into account in computing the tax.

Effective date.—This provision applies to taxable years beginning after December 31, 1969.

3. Penalties for Failure to Pay Tax or Make Deposits (sec. 943 of the Act and secs. 6651 and 6656 of the code)

Prior law.—Under existing law, in the case of a failure to pay income tax when due, simple interest at 6 percent, payable annually, must be paid on the unpaid amount. Existing law also provides a 5 percent per month penalty, up to a maximum of 25 percent, on the amount required to be shown on a return (less amounts already paid) if a taxpayer fails to file a return on the date it is due, unless the failure is due to reasonable cause and not to willful neglect. Interest is also due at the statutory 6 percent rate on unpaid deficiencies.

In the case of failure to make deposits of taxes when due, a penalty was imposed under prior law of 1 percent per month, not exceeding 6 percent in the aggregate.

General reasons for change.—Since the current cost of borrowing money is substantially in excess of the 6 percent interest rate provided by the Internal Revenue Code, it was to the advantage of taxpayers in many cases to file a return on the due date but not to pay the tax shown as owing on the return. For the period the tax remained unpaid, the taxpayer was, in effect, borrowing from the Government the amount of the tax at a 6 percent rate of interest. Similar borrowings could result from failure to pay deficiencies or to make deposits of taxes.

Explanation of provision.—The Act provides a penalty for failure to pay income tax (other than estimated tax) when due, and for failure to pay a deficiency within 10 days of the date of notice and demand. The penalty is one half of 1 percent of the amount of the tax per month, or fraction thereof, during which the failure continues, not exceeding 25 percent in the aggregate. The penalty is not imposed if it is shown that the failure to pay the tax or the deficiency is due to reasonable cause and not to willful neglect.

In the case of failure to pay income tax when due, the penalty is imposed on the amount shown on the return as due, less amounts that have been withheld, estimated tax payments, partial payments, and other applicable credits. In the case of failure to pay a deficiency within 10 days of the date of the notice and demand, the penalty is imposed on the tax stated in the notice reduced by the amount of any partial payments.

In the case of a late filing, the penalty remains as under prior law.

If with respect to any return an addition to tax applies both for failure to file the return on the due date and for failure to pay the tax on the due date, the addition for failure to file is reduced by the addition for failure to pay the tax for any month to which both penalties apply. If with respect to any return an addition applies both for failure to file a return and for failure to pay a deficiency, the addition for failure to pay the deficiency is reduced by the amount of the addition for failure to file that is attributable to the unpaid deficiency for which the notice and demand is made.

If the amount required to be shown as tax on a return is less than the amount shown on the return, the addition for failure to pay the tax is imposed on the lower amount.

With respect to failure to make deposits of tax, the Act changes the 1 percent per month penalty to a flat 5 percent penalty.

Effective date.—With respect to payment of tax shown on a return and payment of deficiencies, the provision applies with respect to

returns due after December 31, 1969 (without regard to extensions of time) and deficiencies the notice and demand for payment of which is made after December 31, 1969. With respect to making of deposits, the provision applies to deposits required to be made after December 31, 1969.

4. Declarations of Estimated Tax by Farmers and Fishermen (sec. 944 of the Act and sec. 6015(f) of the code)

Prior law.—Under prior law, individuals who obtained at least two-thirds of their estimated gross income from farming or fishing were generally excused from filing declarations of estimated tax if on or before February 15 of the succeeding taxable year they filed a tax return for the taxable year for which the declaration was required, and if they paid the full amount of the tax liability shown on the return.

General reasons for change.—It is believed that due to their particular occupational circumstances (e.g., the possibility of severe weather conditions at or about the time a tax return is due) farmers and fishermen frequently find it difficult to file their tax returns by the February 15 deadline. This difficulty has increased in recent years for farmers and fishermen who have been forced to seek (or whose wives have sought) additional outside employment, and who had not received their W-2 forms—showing the amount of earnings and taxes withheld in connection with their outside employment—by the time their tax return was due on February 15.

Explanation of provision.—The Act advances the filing date for tax returns of farmers and fishermen from February 15 to March 1. This was done to provide these individuals with additional time to file their returns so that they might avoid the penalties imposed for not filing declarations of estimated tax on time.

Effective date.—This provision is effective for taxable years beginning after December 31, 1968.

5. Portion of Salary, Wages, or Other Income Exempt From Levy (sec. 945 of the Act and sec. 6334(a) of the code)

Prior law.—Under prior law, if a person liable to pay any Federal tax neglected or refused to pay the tax within 10 days after notice and demand, then in order to secure payment of the tax the Internal Revenue Service could levy upon all property and rights to property (except exempt property) which belonged to the person. Exempt property included unemployment benefits, workman's compensation, and certain annuity and pension payments, but not salary, wages, or other income.

General reasons for change.—Occasionally a judge would issue a decree for the payment of support for minor children, and thereafter discover that the Revenue Service had levied on the individual involved, tying up the individual's income. In such instances, the levy prevented the payment of the amounts granted by the court for the support of minor children.

Explanation of provision.—Under the Act, if a taxpayer is required by a court judgment to contribute to the support of his minor children, then the portion of his salary, wages, or other income which is necessary to comply with the judgment is exempt from levy to pay Federal taxes. This provision does not apply unless the court decree providing

for the support of minor children had been entered prior to the date of the levy.

Effective date.—The provision applies with respect to levies made on or after January 29, 1970.

6. Interest and Penalties in Case of Certain Taxable Years (sec. 946 of the Act)

Prior law.—Under existing law in the case of a failure to pay income tax when due, simple interest at 6 percent payable annually must be paid on the amount of tax owed. There is also a penalty of 5 percent per month, up to a maximum of 25 percent, on the amount required to be shown on a return (less amounts already paid) if a taxpayer fails to file a return on the date it is due unless the failure is due to reasonable cause and not willful neglect. (In addition, the Act imposes certain additional penalties for willful failure to pay income tax—see item 3 above, *Penalties for Failure to Pay Tax or Make Deposits.*)

General reasons for change.—In several situations changes made by the Act affect tax liabilities for years beginning prior to the date of its enactment. In the absence of specific provision to the contrary, these changes could give rise to interest charges and penalties—for example, because of underpayments of estimated tax which are attributable to the repeal of the investment credit or extension of the surcharge.

Explanation of provision.—The Act provides relief from interest and penalties with respect to underpayments of tax and payments of estimated tax where this results from understatement of tax because of any amendments made by the Act.

First, to the extent an underpayment of tax for a taxable year ending before enactment of the Act on December 30, 1969, is attributable to an amendment made by the Act, interest on the underpayment is not to start running until the 90th day after enactment. In other words, taxpayers whose taxable years end before enactment and who pay any underpayment of tax which is attributable to an amendment made by the Act within 90 days after enactment will not incur interest on the underpayment.

Second, a taxpayer who must increase his estimated tax payments for any taxable year beginning before enactment of the Act to take any amendment made by the Act into account is to pay the additional amount of estimated tax ratably over the remaining installments for his taxable year, beginning with the first installment which is due on or after 30 days after the date of enactment of the Act. In other words, the effect of the changes made by the Act on the estimated tax for the entire taxable year is taken into account in determining payments required to be made on the remaining installment dates in order for the taxpayer to avoid penalty for underpayment of estimated tax.

Taxpayers, however, are not to be subject to a penalty for underpayment of the estimated tax for any period prior to the date of the first installment occurring 30 days or more after the date of enactment if they would not have been subject to a penalty under prior law. In other words, the amendments made by the Act are not taken into account in determining the applicability of a penalty for underpayment of estimated tax due prior to the 30th after enactment.

EE. ARTICLE I STATUS FOR TAX COURT AND PROVISION FOR SMALL CLAIMS CASES

(Secs. 951-962 of the Act and secs. 7441-7487 of the code)

Prior law.—Under prior law, the Tax Court of the United States was an independent agency in the Executive Branch of the Government. It was (and is) the forum to which taxpayers may take income, estate, and gift tax cases for redetermination of deficiencies (including a determination that there not only is no deficiency but that there is an overpayment) before paying the taxes. The sixteen judges of the Tax Court were appointed by the President with the advice and consent of the Senate for 12-year terms. However, an appointment to fill a vacancy in the Court was only for the remaining period of the vacancy. The Court had no power to punish for contempt, not even for violations of subpoenas which it was authorized to issue.

The Court provided its own rules of procedure but was to abide by the rules of evidence applicable to nonjury cases in the District Court of the District of Columbia. The Tax Court was required to have a stenographic transcript prepared of all its hearings, to prepare written reports of its opinions (including findings of fact), and to publish those reports.

Judges were required to retire after reaching the age of 70 if they had completed at least 10 years of service; they might retire after 18 years of service at any age. A non-contributory pension was available which entitled a judge to retire at full pay after 24 years on the Court or at proportionately lesser amounts where retirement occurred earlier. A judge who elected this noncontributory pension was not entitled to also receive a Civil Service pension even though rights to the Civil Service pension had accrued before he became a judge. Also, he was not entitled to receive back his Civil Service pension contributions if he elected to receive the Tax Court pension. Survivor benefits of Tax Court judges were (and are) funded by judges' contributions. Each judge had to elect at one of certain specified times before he could provide survivor benefits for his dependents.

General reasons for change.—Two problems arose in connection with the Tax Court—the first was the need for special procedures for handling small claims and the second was the status of the Tax Court itself.

Often taxpayers with small claims believed that there was no inexpensive practical way for them to present their claims before an impartial tribunal and, therefore, they concluded they must abide by the decisions of the Internal Revenue Service. While the Tax Court procedures were less complicated in many respects than those of other courts, they remained formal in nature because the Court and the Internal Revenue Service must consider not just the amount involved in any particular case but also the precedent that it might provide for future cases. In addition, since decisions in these cases are subject to review in the appropriate Court of Appeals (and then, perhaps, in the Supreme Court), a complete record had to be prepared of the proceedings in each case and the Court's findings of fact and opinion had to be sufficiently detailed to permit a proper review. Although the Tax Court instituted simplified procedures in small cases, formal rules

of evidence often constitute a difficult barrier to the taxpayer who represents himself. The Congress concluded that taxpayers with small cases need to have practical access to the Tax Court.

Since the Tax Court has only judicial duties, the Congress believed it was anomalous to continue to classify it with quasi-judicial executive agencies that have rulemaking and investigatory functions. The status of the Tax Court and the respect accorded to its decisions are high among those familiar with its work. However, its constitutional status as an executive agency, no matter how independent, raised questions in the minds of some as to whether it was appropriate for one executive agency to be sitting in judgment on the determinations of another executive agency. Also, it seemed inappropriate that the Tax Court was required to look to the District Courts to enforce its own authority.

Because a Tax Court judge, under prior law, was first appointed for the remainder of his predecessor's term, his first appointment might well be for only two or three years or even as short a period as several months. A judge might be appointed at any age and would not be required to retire at age 70 unless he had already served for 10 years. (Unless a judge served that long, he would not be eligible for a Tax Court retirement pension under prior law.) The Congress believed that Tax Court judges should have longer, more uniform terms, but should not serve past the age of 70 except under the limited circumstances pertaining to the recall of retired judges.

The Tax Court retirement provisions also were defective in several respects. For example, they did not authorize retirement for disability although this is available to District Court judges. Moreover, Tax Court judges were neither permitted to collect Civil Service retirement benefits if they elected Tax Court retirement nor were they permitted to receive back their contributions to the Civil Service retirement fund, even though District Court judges who have already achieved eligibility under Civil Service retirement are permitted to collect such benefits in addition to their pensions as judges or to receive refunds of their Civil Service contributions. Also, District Court pensions were far more favorable as a proportion of salary than those available to Tax Court judges. Finally, the prior provisions severely restricted the occasions when a Tax Court judge might apply for survivor benefits.

Explanation of provision.—The Act establishes a procedure whereby taxpayers with relatively small claims may have reasonable access to the Tax Court without impairing the Court's ability to deal with the cases coming before it. The Act also makes the Tax Court an Article I court rather than an executive agency and expands its powers accordingly. Further, the Tax Court retirement and survivors provisions are revised to bring them more nearly in accord with those applicable to District Court judges.

The Act provides that in a small case (where neither the disputed amount of the deficiency nor the claimed overpayment exceeds \$1,000 as to any one taxable year or as to an estate tax)¹ a simplified and relatively informal procedure is to be available to the taxpayer. In such a case the decision will be based upon a brief summary opinion instead of formal findings of fact, etc., will not be a precedent for future cases, and will not be reviewable on appeal. Moreover, in such a case the Court will not have the power to determine a deficiency or over-

¹ This provides a special method for dealing with small cases that are already within the Tax Court's jurisdiction; it does not expand the categories of cases that the Court may hear.

payment in dispute exceeding \$1,000 for any taxable year or for an estate tax.² In addition, the Court will have discretion as to the rules of evidence and procedure to be applied (leaving the Court with the freedom to adapt any small claims court rules that are appropriate) but it is expected that the Court will follow relatively informal rules whenever possible.

Use of this procedure will be optional with the taxpayer unless the Tax Court (presumably upon the request of the Internal Revenue Service) decides before the hearing that the case involves an important tax policy issue which should be heard under normal procedures and should be subject to appeal. Commissioners may be used by the Tax Court in such cases and are to be paid at the same rate as Commissioners of the Court of Claims.

If it becomes evident to the Court during, or at the end of, the trial of a small claim case that the deficiency or overpayment should be changed by more than \$1,000, then the Court has discretion to shift the case to the procedures for regular Tax Court cases. This discretion is expected to be exercised only in unusual cases, where the Court deems it appropriate, taking into account all considerations bearing on the fairness of the change, including the costs involved for all parties.

In establishing a small claims procedure the Act is purposely broad to allow the Court latitude in setting up a small claims division so as to meet the varied and difficult problems, both substantive and procedural, which may arise. It is contemplated the Court will report its progress to the Congress from time to time.

The Act establishes the Tax Court as a court under Article I of the Constitution, dealing with the Legislative Branch.³

At the present time, the Court of Military Appeals is the only other Article I court. Other courts, however, have enjoyed this status in the past, including the Court of Claims. In accordance with this change, the Tax Court is given the same powers regarding contempt, and the carrying out of its writs, orders, etc., that Congress has previously given to the District Courts.

The method of appointment of judges to the Court (by the President with the advice and consent of the Senate) is not changed by the Act. However, the term of office is established as 15 years from the date the judge first takes office. A judge may not be appointed for the first time after reaching the age of 65. The amount and method of payment of the Tax Court judges' salaries are made identical with those of District Court judges. (The rules were identical under prior law, but were stated in different places in the United States Code for the different judges.)

² The Court will not be permitted to determine a deficiency more than \$1,000 above the undisputed amount in the notice of deficiency. For example, if a deficiency of \$1,200 were determined by the Internal Revenue Service and the taxpayer put in issue in the Tax Court only \$300 of that deficiency, then the remaining \$900 of the deficiency would have been conceded and the maximum deficiency that could be determined would be \$1,900. (or \$1,000 more than the deficiency already conceded, but only if the government increases the deficiency it asserts by an additional \$700 over and above the \$300 initially at issue). Prior law is not changed in that the Service would have the burden of proof as to the \$700 above its original determination of deficiency. By the same token, once the taxpayer invoked the small claims procedure and the Tax Court concurred, he could not have the deficiency reduced below \$200. However, as indicated below these limitations could be avoided in certain circumstances.

³ The limitations of Article III of the Constitution, relating to life tenure and maintenance of compensation, do not apply to Article I courts. The Act does not place the Tax Court under the supervision of the Judicial Conference or the Director of the Administrative Office of the Article III courts or give them any power or control over the Tax Court.

The provisions regarding retirement are revised to require retirement at age 70, whether or not the judge has completed 10 years service by that time. The provisions of existing law authorizing the use of retired judges on recall to relieve heavy case loads are unchanged by the Act.

As in the case of the District Court, the Act permits a judge to retire at age 65 if he has served at least 15 years; he is permitted to retire at a younger age with 15 years service if he is available for reappointment at the conclusion of his term but is not reappointed. The Act requires a Tax Court judge to retire if he is permanently disabled. In general, retirement under these provisions is at the full pay of the office,⁴ except that if the judge has served less than 10 years when he reaches the mandatory retirement age of 70, then his retirement pension is apportioned in accordance with the number of years he has served. If the judge has served less than 10 years and is retired because of disability, then his pension is half the salary of the office. The disability provisions are patterned after those of District Court judges.

The Act retains the provisions of prior law that a Tax Court judge may not receive both Civil Service retirement and Tax Court retirement pensions, but the Act permits the judge to receive back any contributions he made to the Civil Service retirement fund if he elects the Tax Court pension.

Under the Act, an election to provide for survivors' benefits may be made at any time the person is a judge instead of only at the specific times set forth in prior law. The Act makes no change in the amounts the judge is required to contribute and no change in the level of survivors' benefits.

Changes are made as to time for appeal and terminology in order to conform the code provisions to the Federal Rules of Appellate Procedure. The code provision for appealing from Tax Court decisions within 3 months after entry of decision, is changed to 90 days. In order to resolve a number of cases in which appellate jurisdiction is being challenged because the petition for review was filed within 3 months but after 90 days, the Act provides that a petition is timely filed if it is filed within either time period. This applies in cases where the Tax Court decision is entered before the thirtieth day after the Act's enactment (that is, before January 29, 1970). Thereafter, the 90-day rule is to apply.

The Act specifically provides that the United States Tax Court established by it is a continuation of the prior Tax Court of the United States. The Act is to have no prejudicial effect upon litigation, jurisdiction, etc., as to matters pending at the date of enactment.

Effective dates.—The provisions dealing with the treatment of small tax cases will become effective one year after the date of enactment. This is done so that the Court and the Internal Revenue Service will have sufficient time to examine into any new procedures and rules that would be appropriate in dealing with such cases. The other Tax Court changes became effective on the date of enactment, except that in the case of judges who were members of the Court on the day of enactment, special rules are provided with regard to their status for retirement purposes, and their current terms of office will expire on the dates they would have expired under prior law. The changes conforming to the

⁴ If the salary of Tax Court judges is changed at a later date, the salaries of retired judges are adjusted accordingly. This rule was in prior law and is not changed by the Act.

Federal Rules of Appellate Procedure took effect 30 days after enactment.

Revenue effect.—These provisions are expected to have no revenue effect.

FF. INCREASE IN SOCIAL SECURITY BENEFITS

(Title X of the Act)

The Act increases OASDI benefits by 15 percent as of January 1970, raising the minimum monthly benefit from \$55 to \$64. Benefits for individuals age 72 or over who have no coverage or insufficient coverage to qualify for regular benefits are also increased 15 percent, raising their monthly minimum from \$40 to \$46 (from \$60 to \$69 for a married couple). The \$105 limit on a wife's, husband's, widow's, and widower's benefit is removed.

To guarantee that at least part of the OASDI benefit increase will be reflected in the total income of aged, blind, and disabled public assistance recipients, the Act required the States to assure that every recipient who received an OASDI benefit increase would receive an increase in his total assistance plus OASDI payments equal to the lesser of \$4 a month or the increase in his OASDI benefits. This provision applied only to the period before July, 1970. In addition, the States were required to disregard, in determining the need for public assistance, the OASDI benefit increase for January and February 1970, which was paid retroactively by separate check in April.

The increase in social security benefits is estimated to increase payments by \$3.9 billion for 1970 and \$4.4 billion in 1971, the first full year in which the higher benefits are paid. Social security taxes are not increased; the benefits are financed from the actuarial surplus in the OASI trust fund. Allocation of taxes between OASI and the disability trust funds is modified as required to finance the 15-percent benefit increase.





