DESCRIPTION OF TAX BILLS

(S. 1928 and S. 2281)

Scheduled for a Hearing

Before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

on

May 7, 1982

Prepared by the Staff

of the

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INTRODUCTION

The bills described in this document have been scheduled for a public hearing on May 7, 1982, before the Senate Finance Subcommittee on Taxation and Debt Management.

There are two bills scheduled for the hearing: S. 1928, relating to amounts received in settlement of Westinghouse uranium litigation, and S. 2281, relating to special one-year rules for charitable contributions of technological equipment to primary and secondary schools for use in educating students.

The first part of the document is a summary of the bills. (The bills are presented in the document in the same order as listed in the press release announcing the hearing.) This is followed by a more detailed description of each bill, including present law, issues, explanation of the bill, and effective date.

I. SUMMARY

1. S. 2281--Senators Danforth and Cranston

Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools

Present law

Under present law, the amount of charitable deduction allowed for a contribution of ordinary-income property (such as a donation of inventory by a manufacturer) is limited, subject to certain exceptions, to the donor's cost basis in the property (Code sec. 170(e)). Also under present law, the maximum charitable deduction allowed to a corporation in one year for the total amount of its contributions is 10 percent of the corporation's taxable income for the year, with a five-year carryover of any excess. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.)

Explanation of the bill

The bill would provide special rules for a charitable contribution by a corporation of a computer, or other sophisticated technological equipment, to a primary or secondary school for use directly in the education of students.

Under the bill, a deduction would be allowed for the sum of the donor's cost basis in the property plus 50 percent of the difference between the property's fair market value and basis, but not to exceed twice the basis. Also, the bill would increase, to up to 30 percent of taxable income, the limitation on the aggregate amount deductible in one year by a corporate donor which makes such contributions.

The special charitable deduction rules under the bill would apply to qualifying donations of computers or other sophisticated technological equipment only if made within one year after enactment of the bill.

2. S. 1928--Senators Danforth, Byrd (of Va.), and Kassebaum

Amounts Received in Settlement of Westinghouse Uranium Litigation

Background

In 1979, Westinghouse Electric Corporation agreed to settle litigation with several electric utilities involving contracts to sell nuclear fuel. Under the terms of the settlements,

Westinghouse agreed to provide immediate cash payments and future price discounts on the purchase of nuclear fuel and other goods and services. In exchange, Westinghouse was relieved of its obligation to provide nuclear fuel at the price it had contracted for in the late 1960s and early 1970s.

Explanation of the bill

The bill would provide that a utility would not include any amount in income for discounts or price reductions provided pursuant to its settlement with Westinghouse. Any price reduction under the settlement would be excluded from the cost of the goods or services to which the reduction relates; thus, for example, any amount of investment credit or depreciation allowance would be based on the utility's cost after taking into account any reduction provided under the settlement.

The provisions of the bill would be effective for the taxable year in which the taxpayer obtained its settlement with Westinghouse and for all subsequent taxable years.

II. DESCRIPTION OF BILLS

1. S. 2281--Senators Danforth and Cranston

Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools

Present law

General reduction rule

A taxpayer generally may deduct, within certain limitations, the amount of cash or the fair market value of other property contributed to qualified charitable organizations. However, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)). 1/ Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Exceptions

Under present law, charitable contributions by corporations of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule.

The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)).

1/ In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

The second exception, enacted in the Economic Recovery Tax Act of 1981, is for corporate donations of newly constructed scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for an amount in excess of twice the basis of the property (sec. 170(e)(3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a greater tax incentive than would be available if the general reduction rule applied for charitable contributions of certain types of ordinary-income property for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Overall deduction limitation

The total charitable deduction allowed to a corporation is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.) If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

Issues

1. The first issue is whether contributions by businesses to schools for use in educating students where there might be a benefit to the donor (e.g., through increasing a market for the business' products) should be treated for income tax purposes as charitable contributions (in which case a charitable deduction may be allowed for an amount in excess of the cost

basis of the donated item), or as noncharitable promotional expenditures (in which case the deduction would be limited to the item's cost to the donor). 2/

2. If such contributions are to be treated as charitable contributions, the second principal issue is whether an exception to the general reduction rule applicable to charitable contributions of inventory should be made in the case of qualifying contributions of computers, etc.; i.e., should any deduction in excess of the cost of the goods to the donor be allowed, and if so, how much. Related issues are (a) what kinds of property should be eligible for any special treatment (for example, should all types of sophisticated technological equipment be eligible or only computers, and if so limited, how qualifying computers should be defined); and (b) whether any special treatment should be accorded to all taxpayers, or limited (for example) to manufacturers.

3. The third principal issue is whether, in the case of such contributions, the limitation on the aggregate charitable deduction allowed in one year to a corporation should be increased above the general 10 percent limitation.

Explanation of the bill

Overview

The bill would provide a larger charitable deduction (than would be allowed under the general reduction rule), and would increase the general limitation on the aggregate amount of corporate contributions deductible in a year, for charitable contributions by corporations of computers or other sophisticated technological equipment, if contributed to a primary or secondary school, and if used by the school directly in the education of students. These special charitable deduction provisions would apply only to qualifying donations which are made within one year after enactment of the bill.

2/ In Singer Co. v. U.S., the U.S. Court of Claims upheld IRS denial of charitable deductions claimed by a manufacturer for the amount of discounts allowed on purchases of sewing machines by schools and colleges (449 F.2d 413) (Ct. Cl. 1971)).

In that case, the court had found that the school discounts were offered "for the predominant purpose of encouraging [the schools] to interest and train young women in the art of machine sewing, thereby enlarging the future potential market by developing prospective purchasers of home sewing machines and, more particularly, Singer machines--the brand on which the future buyers learned to sew." The court concluded that the manufacturer's predominant reason for granting such discounts was other than charitable, notwithstanding that the company said it would have provided the discounts even if it had a total monopoly of the sewing machine market, and even though a company survey showed that fewer than two percent of its regular retail customers had been influenced in buying by previous school training. Since the company expected a return in the nature of future increased sales, the court concluded that the company received a quid pro quo for the discounts which was substantial and was therefore inconsistent with allowing charitable deductions.

The principal intended beneficiary of the bill is Apple Computer, Inc. The provisions of the bill would also benefit any other corporate taxpayer which, during the one-year period following enactment of the bill, makes qualifying charitable contributions of computers or other sophisticated technological equipment.

Requirements for favorable treatment

In order for the special deduction rules of the bill to apply, there must be a charitable contribution (as defined under sec. 170(c)) by a corporation 3/ which satisfies the following requirements:

(1) The donated property is a computer or other sophisticated technological equipment or apparatus, and is of an inventory nature (within the meaning of sec. 1221(1));

(2) The property is donated to an educational organization (described in sec. 170(b)(1)(A)(ii)) 4/ other than an institution of higher education (as defined in sec. 3304(f)); 5/

3/ The bill would not apply in the case of a corporation which is a subchapter S corporation (as defined in sec. 1371(b)); a personal holding company (as defined in sec. 542); or a service organization (as defined in sec. 414(m)(3)).

4/ An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools,***" and includes both public and private schools (Reg. §1.170A-9(b)(1)).

5/ An institution of higher education, as defined in sec. 3304(f), means an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

(3) The contribution is made within two years of substantial completion of construction of the property, and within one year after the enactment of the bill;

(4) The original use of the donated property is by the school;

(5) All the use of the donated property by the school is directly in the education of students in the United States;

(6) The donated property is not transferred by the school in exchange for money, other property, or services; and

(7) The donor receives a written statement from the school representing that the use and disposition of the donated property will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a high school of a computer with a cost basis of $5X, and a fair market value of $16X, the bill would allow the manufacturer a charitable deduction of $10X (twice the $5X basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by $4.6X, or 92 percent of the cost of manufacture. The out-of-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be $0.4X. If in the example the fair market value of the computer was $11X, the deduction would be $8X ($5X basis plus 1/2 of the $6X difference between value and basis), and the out-of-pocket cost to the manufacturer would be $1.32X ($5X cost less $3.68X tax benefit).

Increased overall limitation

The bill also would provide that the limitation on the aggregate charitable contribution deduction allowed to a corporation (under present law, 10 percent of taxable income, computed with certain adjustments) would be increased by the amount of the taxpayer's qualifying contributions of computers or other sophisticated technological equipment. However, the limit as so increased could not exceed 30 percent of taxable income (as computed with certain adjustments).

Effective date

The provisions of the bill would apply to taxable years ending after the date of enactment. The special deduction rules provided under the bill would apply only to qualifying contributions which are made within one year after enactment.

2. S. 1928--Senators Danforth, Byrd (of Va.), and Kassebaum

Amounts Received in Settlement of Westinghouse Uranium Litigation

Background

During the late 1960s and early 1970s, electric utilities throughout the country entered into contracts with Westinghouse Electric Corporation to purchase nuclear fuel at an average contract price of about $8-$10 per pound of uranium. Westinghouse planned to fulfill its contract obligations through its own production and by purchases from other sources. However, when the market price for uranium rose to more than $25 per pound in 1975, Westinghouse refused to deliver uranium at the contract price, arguing that it was excused from its contractual obligations by reason of commercial impracticability. This action by Westinghouse gave rise to court suits which were settled in 1979, by which time the price of uranium had increased to over $40 per pound.

Under the terms of the settlements with electric utilities, Westinghouse agreed to provide cash payments, a future supply of uranium at prices higher than the original contract price but less than market prices, plus other goods and services at discounted prices. The total settlement benefits are estimated to exceed $1.8 billion and will be received by the utilities over a period as long as 28 years from the year of the settlement.

Present law

In a private letter ruling (LTR 8134189), the Internal Revenue Service has taken the position that the settlements constitute taxable events, generally resulting in taxation to the utilities (in the year of the settlement) of the present value of the settlement benefits. For accrual-basis taxpayers, the Service's position is that damages for breach of contract are includible in income for the year in which the settlement is reached.

The correctness of the Service's letter ruling is disputed in part by the utilities. It has been argued by some that the payment of cash is the only taxable event under the Westinghouse settlement, and that establishing the right to receive future discounts on purchases should be viewed as analogous to a

nontaxable adjustment of contract terms. Thus, it is argued that price discounts on nuclear fuel or other goods and services resulting from the settlement should be treated as having the same tax consequences as changed prices resulting from renegotiated contracts.

Issue

The issue is whether the present value of future price discounts on nuclear fuel and other goods and services that Westinghouse has agreed to provide in settlement of its litigation with electric utilities should be included in the income of the utilities for the year of the settlement.

Explanation of the bill

Under the bill, no amount would be included in the income of a utility by reason of discounts or price reductions to be provided by Westinghouse Electric Corporation in settlement of the litigation of Westinghouse's contractual obligation to provide nuclear fuel to the utility. For purposes of determining investment credits, depreciation allowances, deductions for business expenses, etc., the utility's cost for the goods or services is the cost as reduced by the price discounts or reductions. The bill would not affect the tax consequences of any cash payments by Westinghouse to utilities under the settlement.

The bill does not provide any special rule for determining the taxable year for which deductions, if any, are allowable to Westinghouse with respect to the settlement.

Effective date

The provisions of the bill would apply to the taxable year in which the taxpayer obtained its settlement with Westinghouse and to all subsequent taxable years.