[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (H.R. 699, H.R. 2476, H.R. 2504, H.R. 2831, H.R. 3096, H.R. 3173, H.R. 3592, and H.R. 3593)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON SEPTEMBER 21, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on September 21, 1983, on the eight bills described in this pamphlet.

The eight bills scheduled for the hearing are: (1) H.R. 699 (relating to the tax treatment of certain conversions of residential rental property into condominium units); (2) H.R. 2476 (relating to nonrecognition of gain from any net gift made before March 4, 1981); (3) H.R. 2504 (relating to exclusion of interest on obligations issued by certain educational organizations); (4) H.R. 2831 (relating to disaster loss deduction for residential losses from mudslides, earthslides, or flooding); (5) H.R. 3096 (relating to prevention of certain abuses involving tax straddles and to prevent the avoidance of tax through the use of foreign corporations); (6) H.R. 3173 (relating to application of cash or deferred arrangement rules to money purchase plans); (7) H.R. 3592 (relating to rollover of certain partial distributions from qualified plans, and for other purposes); and (8) H.R. 3593 (relating to medical care deduction for lodging away from home in certain cases).

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, effective dates, and revenue effects.

I. SUMMARY

1. H.R. 699—Messrs. Stark and Archer

Tax Treatment of Certain Conversions of Residential Rental Property Into Condominium Units

Under present law, the entire gain on the conversion of residential rental property into condominiums and the individual sale of those condominiums generally is treated as ordinary income to the seller. As a result, owners of residential rental property who wish to convert it into condominiums often sell the entire property to another person who converts the property and sells the individual condominium units. If the entire property is sold in one sale prior to conversion, the owner generally will receive capital gain treatment with respect to the gain on the sale of the property .

The bill would provide that a taxpayer could elect to treat the conversion of qualified residential rental property into condominium units as a sale at the time of conversion for purposes of determining the proportion of the gain realized on disposition of the units to be recognized as capital gain. The amount of unrealized gain determined at the time of the conversion would be treated, when realized, as capital gain, while any additional gain on the disposition of the units would be treated as ordinary income. The provision would apply to conversions after the date of enactment of the bill in taxable years ending after such date.

2. H.R. 2476—Messrs. Duncan, Boner, and Skelton

No Gain Recognized from any Net Gift Made Before March 4, 1981

Present law taxes income "from whatever source derived," including the benefit resulting from the discharge of one's indebtedness by another party (Code sec. 61(a)(12)). Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Liability for the gift tax is on the donor of the transferred property.

A donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer (i.e., make a "net gift"). On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner,* that the discharge of a donor's liability for gift tax by the donee of a net gift gives rise to income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

The bill would provide that no income would be recognized to donors who made net gifts before March 4, 1981 (the date on which an initial decision by the Court of Appeals held that the donor in the *Diedrich* case recognized income).

3. H.R. 2504—Messrs. Schulze and Murtha

Exemption for Interest on Obligations Issued by Certain Educational Organizations

The bill would provide a tax exemption for the interest on obligations of the Pennsylvania State University.

4. H.R. 2831—Mr. Panetta

Disaster Loss Deduction for Residential Losses from Mudslides, Earthslides, or Flooding

Present law allows a deduction for nonbusiness casualty losses to the extent such losses exceed 10 percent of adjusted gross income. In general, a deduction is allowed only when the casualty (e.g. storm, flood or earthquake) causes actual physical damage to the taxpayer's property.

The bill would provide that a taxpayer whose residence is located in a Federally declared disaster area, and who is ordered by a State or local government to demolish or relocate the residence because of a danger of mudslides, earthslides, or flooding, may deduct any loss attributable to the demolition or evacuation order as a casualty loss.

5. H.R. 3096—Mr. Stark

Tax Straddle Abuses and Use of Foreign Corporations To Avoid U.S. Tax

Offshore commodity funds

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate.

The bill would, in certain cases, apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends. It would also generally treat gains of U.S. shareholders from such investments as ordinary income.

Corporations formed to straddle

Taxpayers may attempt to avoid the tax straddle rules by forming corporations, typically foreign corporations, to take positions to offset their own. The bill would treat such stock ownership as a position for the purposes of the straddle rules. This treatment would prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes.

6. H.R. 3173—Mr. Matsui

Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans

The Employee Retirement Income Security Act of 1974 (ERISA) provided that amounts deferred by an employee pursuant to a cash or deferred arrangement or a salary reduction arrangement under a tax-qualified profit-sharing, stock bonus, or money purchase pension plan are excluded from the employee's income if (1) the plan was in existence on June 27, 1974, and (2) the applicable requirements of prior law were satisfied. This tax treatment for then existing plans was preserved, pending study by the Congress of the appropriate treatment for cash or deferred and salary reduction arrangements.

Under the Revenue Act of 1978, amounts deferred by an employee after 1979 pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing or stock bonus plan are excluded from the employee's income only if certain requirements added by the Act are met. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Under the bill, amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase pension plan would be excluded from the employee's income if the plan was in existence on June 27, 1974, and contributions by employees and the employer do not exceed the levels permitted under the plan's contribution formula on that date. In addition, the plan must satisfy rules added by the 1978 Revenue Act with respect to employee participation and prohibited discrimination in favor of officers, shareholders, or highly compensated employees.

The bill would apply to money purchase pension plans maintained by taxable employers or tax-exempt organizations. The bill generally would apply retroactively for plan years beginning after 1980, and to contributions made after that date.

7. H.R. 3592—Mr. Rostenkowski and Mr. Conable

Rollover of Certain Partial Distributions from Qualified Plans, and for Other Purposes

a. Rollover of certain partial distributions from qualified plans

Under present law, if the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee from a qualified pension, profit-sharing, or stock bonus plan as a qualifying rollover distribution, all or any portion of the distribution generally may be rolled over, within 60 days of the date of the distribution, to another qualified pension, etc., plan or an individual retirement account, annuity, or retirement bond (an IRA). If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution. Similar rules apply to benefits under tax-sheltered annuity contracts.

A qualifying rollover distribution is one or more distributions (1) within one taxable year of the employee on account of the termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under the plan, (2) that constitute a lump sum distribution, or (3) that constitute a distribution of accumulated deductible employee contributions. Present law provides that if no part of a lump sum distribution from a qualified pension, etc., plan is rolled over, it may be accorded special 10-year income averaging (and, in some cases, long-term capital gain) treatment. Additionally, if the lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged.

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, etc., plan or a tax-sheltered annuity contract could be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution would be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment as prescribed by the Secretary of the Treasury. If partial rollover treatment is elected, any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) would not be eligible for the special 10-year income averaging or the long-term capital gain treatment accorded lump sum distributions, and no special treatment would be accorded to unrealized appreciation of employer securities.

The provision would be effective for distributions made after December 31, 1983, in taxable years ending after that date.

b. Treatment of certain transactions between related parties

Under present law, an accrual-basis taxpayer, in order to obtain a deduction for business expenses or interest accrued to a cash-basis person related to the taxpayer, must ordinarily pay such items not later than 2-1/2 months after the close of its taxable year. In the case of a subchapter S corporation, payments owed to a related party cash basis taxpayer, including a shareholder who owns at least 2 percent of the stock of the corporation, are deductible only when paid, whether or not paid after the expiration of the 2 1/2-month period. Also, present law denies losses on sales or exchanges of property between related parties.

The bill would amend the related party rules so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. Also, the present law rules relating to payments by subchapter S corporations would be extended to payments by partnerships. Thus, an accrual basis partnership generally could not deduct unpaid amounts accrued to any cash basis partner (or person related to the partner) and any deduction for those amounts would be allowable only when paid.

Finally, the bill would extend the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50-percent control test.

These provisions would apply to taxable years beginning after 1983.

c. Preferred stock eligible for small business corporation stock treatment

Under present law, a taxpayer is allowed to deduct, as an ordinary loss, up to $50,000 ($100,000 in the case of a joint return) of loss on the disposition of "section 1244 stock." Generally, "section 1244 stock" means certain common stock of a domestic small business corporation.

The bill, which would apply to stock issued after the date of enactment, would extend the definition of "section 1244 stock" to include preferred stock of qualified small business corporations.

d. Coordination of certain amendments made by the Highway Revenue Act of 1982 and Public Law 97-473

The Highway Revenue Act of 1982 added a provision relating to interest on certain tax-exempt obligations. Public Law 97-473 may have inadvertently repealed the section contained in the Highway Revenue Act. The bill would clarify that the provision of the Highway Revenue Act was not repealed.

8. H.R. 3593—Messrs. Stark and Conable

Medical Care Deduction Allowed For Lodging Away from Home

Under present law, individuals who itemize deductions may deduct certain expenses paid for medical care. Amounts paid for transportation primarily for and essential to medical care are treated as expenses paid for medical care and are deductible. Amounts paid for lodging while away from home, however, are not deductible.

Under the bill, certain expenses for lodging while away from home would be treated as expenses paid for medical care and would be deductible. The provisions of the bill would be effective for taxable years beginning after 1983.

II. DESCRIPTION OF THE BILLS

1. H.R. 699—Messrs. Stark and Archer

Tax Treatment of Certain Conversions of Residential Rental Property Into Condominium Units

Present Law

Under present law, gain or loss on the sale or exchange of a capital asset is treated as capital gain or loss. If the capital asset is held for more than one year, the resultant capital gain or loss is long-term capital gain or loss. Long-term capital gain is taxed at preferential rates.

In general, a capital asset is any property owned by a taxpayer, whether or not connected with his trade or business other than certain exceptions. Under one of those exceptions, an asset is not a capital asset if it is stock in trade of the taxpayer or other property of a kind which would properly be included in inventory of the taxpayer if on hand at the close of the taxable year, or is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (Code sec. 1221(1)).

The question of whether or not property is held primarily for sale to customers in the ordinary course of a trade or business is one of fact. Among the factors considered in making this determination are the intent of the owner (whether the property was acquired or was held for investment or for subdivision and resale in the ordinary course of a trade or business); whether the sale was merely the liquidation of an investment; whether there are sales activities such as development and improvement work on the property; whether there is promotional activity such as advertising, the use of salesmen, or payment of commissions; whether the proceeds are reinvested in like property; and whether the owner is a dealer in the trade or business.

Present law also provides a special rule for determining whether or not a taxpayer (other than dealers in real estate but including corporations in certain cases) will be treated as holding real property for sale in the ordinary course of a trade or business (section 1237). If the requirements of section 1237 are met, gain from the sale or exchange of the first 5 parcels in the tract is treated as capital gain. In addition, only five percent of the gain on the sale or exchange of the sixth and succeeding parcels is treated as ordinary income.

In order to be eligible for the special treatment provided by section 1237, the taxpayer must not have held the tract or any parcel thereof for sale in the ordinary course of a trade or business (and must not hold other real estate for sale to customers in the ordinary course of a trade or business in the year of the sale under sec.

1237). In addition, the taxpayer must not have made "substantial" improvements (other than "necessary" improvements and certain marketing expenditures) to the tract which substantially enhance the value of the lot or parcel sold. Finally, the taxpayer must have held the parcel sold for 5 years unless acquired by inheritance or devise.

The Internal Revenue Service has held that section 1237 of the Code does not apply to the conversion of rental units in an apartment building to condominiums for resale to the public (Rev. Rul. 80-216, 1980-2 C.B. 239). However, the fact that section 1237 does not apply to such a conversion does not imply that the resale of such condominiums must necessarily be treated as ordinary income. [1]

Explanation of the Bill

Under the bill, a taxpayer could elect to treat the conversion of any qualified residential rental property into condominium units as a sale of the property, but only for purposes of computing the proportion of the gain to be recognized as capital gain when the units are disposed of and the gain is realized. [2] In order to determine the amount of the capital gain, the property would be treated as having been sold for an amount equal to its fair market value, as residential property, immediately before the conversion. Any substantial improvement to the property, made in anticipation of the conversion, would not be taken into account in determining the fair market value.

At the time each dwelling unit is sold, a portion of the total gain realized would be recognized as capital gain; the remaining portion would be recognized as ordinary income. The portion of the gain from the sale of an individual unit that would be treated as capital gain would be equal to the ratio of the gain at the time of the conversion of the whole complex bears to the total gain from the sale of all individual units.

Qualified residential property would be defined as property which the taxpayer holds as residential rental property and which the taxpayer held as residential property for at least 5 continuous years immediately before the conversion. The 5-year rule would not apply to property acquired by inheritance or devise.

No loss would be recognized if treating the conversion of the property as a sale under the provisions of this bill would result in a loss.

Effective Date

The bill would apply to conversions after the date of enactment in taxable years ending after such date.

Revenue Effect

The revenue effect of this bill is not available at this time.

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[1] See, IRS Letter Ruling 8204031, October 27, 1981.

[2] It is unclear from the bill whether the property would be treated as sold only for purposes of computing the amount of capital gain to be recognized when the gain is, in fact, realized, or whether the unrealized capital gain would be recognized at the time of the conversion. It is our understanding that the intent of the bill is as described in this explanation.

24-961 O - 83 - 2

2. H.R. 2476—Messrs. Duncan, Boner, and Skelton

No Gain Recognized from any Net Gift made before March 4, 1981

Present Law

The Federal income tax is imposed on income "from whatever source derived" (Code sec. 61). Income may be realized from a variety of indirect means as well as from direct transfers. For example, the benefit resulting from the discharge of one's indebtedness by another party constitutes gross income (sec. 61(a)(12); *Old Colony Tr. Co.* v. *Commissioner,* 279 U.S. 716 (1929); *Crane* v. *Commissioner,* 331 U.S. 1 (1947)).

Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Responsibility for payment of the gift tax is on the donor of the transferred property (sec. 2502), and the gift tax is determined by reference to the value of the property transferred by the donor.

In most cases, the value of the transferred property does not include the amount of gift tax paid by the donor. However, a donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer. In such cases, the amount of the gift is less than the full value of the transferred property, and the donee discharges a debt of the donor with the balance of the transferred value (i.e., a "net gift" is made).

On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner* [1] that payment of gift tax by a donee results in income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

Explanation of the Bill

The bill would provide that payment of (or agreement to pay) gift tax by a donee with respect to gifts made before March 4, 1981, would not result in income to the donor whose gift tax liability was thereby discharged. (March 4, 1981 was the date on which the U.S. Court of Appeals for the Eighth Circuit held that the donor in the *Diedrich* case was required to recognize income from the disputed transfers.) The provisions of the bill would apply both to Federal gift tax and to any gift tax imposed on such transfers by a State.

Effective Date

The provisions of the bill would be effective on the date of enactment. The period of limitations for filing a claim for refund would be extended or reopened for up to one year after the date of the

[1] 457 U.S. 191 (1982).

bill's enactment to permit a claim for refund to be filed in any case in which that period expired before that time.

Revenue Effect

The revenue effect of this bill is not available at this time.

3. H.R. 2504—Messrs. Schulze and Murtha

Exemption of Interest on Obligations Issued by Certain Educational Organizations

Present Law

Federal income tax rules

Tax exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services, including schools, roads, water, sewer, and general improvement projects and the financing of public debt. Additionally, State and local governments may provide tax-exempt financing for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations (including tax-exempt colleges and universities).

Treasury regulations provide that State and local obligations include obligations issued by or on behalf of a State or local governmental unit by authorities empowered to issue such obligations. Treas. Reg. Sec. 1.103-1(b). The courts have held that whether an obligation has been issued by or on behalf of a State or local government unit depends on a variety of factors, including the degree of sovereign power exercised by the issuing authority and the relationship of the authority to the State or local government.[1]

Scholarship funding bonds

In addition to State and local obligations, qualified scholarship funding bonds are exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. To qualify for tax exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over any income to the State or a political subdivision.

Federal land-grant colleges

The Morrill Act of 1862 [2] distributed Federal land to the States for the purpose of establishing State-supported colleges. Under the terms of the Act, the proceeds of any sale of distributed land are to constitute a perpetual fund, the interest on which is to be regularly appropriated by the State to the endowment and support of at least

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[1] *Commissioner v. Shamberg's Estate*, 144 F. 2d 998 (2d Cir. 1944), *cert. den.*, 323 U.S. 792 (1945); *Philadelphia Nat'l. Bank v. U.S.*, 666 F.2d 834 (3d Cir. 1981), *cert. den.*, 102 S. Ct. 2904 (1982).

[2] Laws 1862, c. 132, 37th Cong., 2d Sess., July 2, 1862 (7 U.S.C. sec. 301 *et. seq.*).

one college teaching (without excluding other studies) subjects related to the agricultural and mechanical arts.[3] The Federal Government has subsequently made further appropriations to the States for the benefit of the land-grant colleges.

Explanation of the Bill

The bill would provide a tax exemption for the interest on obligations of a college or university created by specific act of the State legislature and for which the State has regularly made appropriations of interest from money derived from the sale of land under the Morrill Act of 1862.[4] To benefit from the exemption, the college or university would be required (1) to qualify as an educational organization within the meaning of the charitable contributions provisions of the Internal Revenue Code,[5] and (2) to grant baccalaureate or higher degrees. The bill would not affect the tax-exempt status of any obligations which qualify for exemption under existing law.

It is understood that the intended beneficiary of the bill is the Pennsylvania State University. However, any educational organization that meets the requirements of the bill would qualify to issue tax-exempt obligations.

Effective Date

The bill would apply generally to obligations issued after the date of enactment. However, the interest on obligations of a qualifying educational organization which were issued after December 31, 1953, would be exempt from tax if the organization received, after December 31, 1953, a Treasury ruling allowing such exemption.

Revenue Effect

It is understood that the bill is intended to benefit only the Pennsylvania State University. If this is the case, the revenue loss is estimated to be less than $10 million per year.

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[3] 7 U.S.C. sec. 304.
[4] 7 U.S.C. sec. 304.
[5] Sec. 170(b)(1)(A)(ii).

4. H.R. 2831—Mr. Panetta

Disaster Loss Deduction for Residential Losses from Mudslides, Earthslides, or Flooding

Present Law

Deduction for casualty losses

The Internal Revenue Code generally does not allow a deduction for nonbusiness losses. However, taxpayers are allowed a deduction for losses not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (sec. 165(c)(3)). The deduction is allowed only to the extent that the loss from any individual occurrence exceeds $100. Additionally, the deduction is allowed only to the extent that the total amount of casualty and theft losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income (sec. 165(h)).

Treasury regulations provide that the amount which may be deducted for a nonbusiness casualty loss is equal to the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value of the property immediately after the casualty, or (2) the taxpayer's adjusted basis for the property (Treas. Reg. sec. 1.165-7(b)).

Requirement of physical damage

The courts and the Internal Revenue Service have generally allowed a deduction for nonbusiness casualty losses only where the casualty (e.g. storm, flood or earthquake) caused actual physical damage to the taxpayer's property. The decline in value of property as a result of dangerous conditions has generally been held insufficient to support a deduction.

In *Kamanski* v. *Commissioner*, 477 F.2d 452 (9th Cir. 1973), *aff'g* 29 T.C.M. 1702 (1970), the United States Court of Appeals for the Ninth Circuit held that taxpayers were not entitled to a deduction for a loss on the sale of their property following a nearby mudslide. The Court held that the decline in value of the property was not due to damage caused by the mudslide itself, but to buyers' predictions of damage from future casualties.

In Rev. Rul. 70-16, 1970-1 C.B. 36, the IRS took the position that a loss upon the sale of a residence condemned as part of the site for flood prevention construction was not a deductible casualty loss. The State legislature had established a flood prevention district because of previous flooding in the area, but the taxpayer's property had not been physically damaged by the flooding. The ruling stated that there was no proximate relationship between the flooding and the loss on the condemnation sale.

Timing of deduction

Casualty losses generally are deductible in the year in which the casualty is sustained.

Present law (sec. 165(i)) provides a special rule for determining the timing of a deduction for a loss attributable to a disaster occurring in an area subsequently determined by the President to warrant Federal assistance under the Disaster Relief Act of 1974.[1] Under this rule, the amount of the loss may, at the election of the taxpayer, be taken into account in determining the taxpayer's liability for the taxable year immediately preceding the year in which the disaster occurred. The election must apply to the entire loss sustained by the taxpayer.

The special rule regarding Federally assisted disaster areas concerns only the timing of deductions. Thus, a taxpayer residing in a disaster area must establish the existence and amount of any loss under the general principles applicable to all taxpayers.

Explanation of the Bill

The bill would provide that a taxpayer whose residence is located in an area determined to warrant Federal assistance under the Disaster Relief Act of 1974, and who is ordered to demolish or relocate the residence because of a danger of mudslides, earthslides, or flooding, may deduct any loss attributable to the demolition or evacuation order as a casualty loss. The order to demolish or relocate the taxpayer's residence would have to be made by the State or local government within 120 days of the Federal determination. Additionally, the order would have to be based on a State or local determination of a danger of mudslides, earthslides, or flooding.

Amounts deductible under the bill would be subject to the timing provisions of existing law for disaster losses. Thus, at the taxpayer's election, these amounts could be deducted on the taxpayer's return for the taxable year immediately preceding the year in which the order to demolish or relocate the residence was made.

Effective Date

The bill would apply to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

Revenue Effect

The revenue effect of this bill is not available at this time.

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[1] P. L. 93-288, 93d Cong., 2d Sess., May 22, 1974 (42 U.S.C. sec. 5121 *et seq.*) The Disaster Relief Act of 1974 empowers the President to declare an area affected by a disaster (storms, floods, earthquakes, etc.) either an "emergency" or a "major disaster" area. The declaration of an emergency permits the Federal government to take immediate steps to protect life, health and property, and to provide various forms of emergency assistance. Where a major disaster is declared, the Federal government is authorized to provide various additional forms of assistance, including financial assistance (including grants and loans) to private parties affected by the disaster.

5. H.R. 3096 — Mr. Stark

Tax Straddle Abuses and Use of Foreign Corporations to Avoid U.S. Tax

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid having a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if most of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are at least in part U.S. source income (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the rules apply only to those U.S.

persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. individual shareholders to current taxation on passive investment income or trading income, but these rules apply only if five or fewer U.S. individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumulated earnings tax (which reaches a maximum rate of 38.5%) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under final and proposed Treasury Regulations, the tax does not apply to foreign source income that is not effectively connected with a U.S. trade or business. (Reg. sec. 1.532-1(c); Proposed Reg. sec. 1.532-1(c)). It may be unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent receives dividends are subject to this tax, however. If the subsidiary distributes all its U.S. source earnings as dividends to its parent, those dividends are generally deductible from accumulated earnings. Therefore, there may be no accumulated earnings at the level of the subsidiary to which the accumulated earnings tax can apply. The parent corporation may attempt to avoid the accumulated earnings tax by having all foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may argue in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation is appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations. (See Reg. sec. 1.532-1(a)(2).) Second, the Code gives the Secretary authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Marked-to-market of futures trading income

The Economic Recovery Tax Act of 1981, Public Law 97-34, adopted a marked-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each such regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this marked-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to the the marked-to-market rule.

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating earnings at the lower capital gains rates after deferring tax on those earnings abroad. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applies to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that does not register under the Investment Company Act avoids the first of these criteria. In addition, certain case law holds that commodities do not constitute securities for purposes of that Act, so that a company that is engaged primarily in the business of investing or trading in commodities may avoid the second criterion.

Straddles

The Code defines a straddle as offsetting positions with respect to personal property. Personal property is defined to include only property (other than corporate stock) of a type which is actively traded. A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property.

Generally, the deduction of losses on positions which are part of a straddle is limited to the amount by which such losses exceed unrecognized gains on any offsetting positions. Some taxpayers have deliberately arranged to hold offsetting positions indirectly through ownership of stock in corporations owning such positions to avoid the straddle rules. That is, they seek to deduct losses despite unrecognized gains in the hands of the corporation that offset the shareholder's losses. Generally, the corporations involved in such transactions are foreign, so as to avoid U.S. tax on their gains.

Offshore commodity funds

A mutual fund may, using some of the rules described above, attempt to defer U.S. tax and to convert trading income to capital gain through the use of two foreign corporations, one of which ("the Parent") owns all the shares of the other ("the Subsidiary").

The fund establishes and operates these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons

The Parent may trade in non-U.S. commodity markets (and will avoid having any U.S. source income), while the Subsidiary will trade in U.S. commodity markets (and will earn all the U.S. source income that either corporation earns). In general, by avoiding contacts with the United States, the Subsidiary may be able to avoid having a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)).

The Parent may be able to avoid U.S. tax because it will be a foreign corporation with no U.S. source income. Its income will consist mainly of (1) dividends from the Subsidiary, which should not be U.S. source, and (2) gains from trading on non-U.S. commodities markets, which will result in foreign source income.

Taxation of U.S. shareholders of foreign corporations

The fund may plan to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders will have to dispose of their shares to receive any income.

To decontrol these corporations for purposes of the anti-tax avoidance rules including the controlled foreign corporation rules, the Parent will restrict transfers of its shares, and it will attempt to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax

The fund may plan its operations so as to try to avoid the accumulated earnings tax. It may try to benefit from the general rule that the tax does not apply to foreign source income that is not effectively connected with a U.S. trade or business. This is one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved will argue that the Subsidiary will not be subject to the tax because it will distribute all its U.S. source earnings as dividends to the Parent. The fund will argue that there are no accumulated earnings at the level of the Subsidiary to which the accumulated earnings tax can apply. The fund plans to avoid the accumulated earnings tax at the level of the Parent by having all the Parent's income be foreign source income not effectively connected with a U.S. trade or business. The validity of these positions under current law, however, is unclear, and the Internal Revenue Service may argue that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary is appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may allege that its corporate structure has no tax avoidance purpose. The issue would be one of intent.

Marked-to-market of futures trading income

U.S. investors in such a fund could avoid the marked-to-market rule by interposing foreign corporations between themselves and the investments.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realizes income from investment by selling the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan is to permit U.S. investors in the pool to realize capital rather than ordinary gain from their investment when they sell. Such treatment would circumvent the Code's rules that attempt to prevent U.S. taxpayers from repatriating earnings at the lower capital gains rates after deferring tax on those earnings abroad. The fund would plan to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would plan to avoid the foreign investment company provision (sec. 1246) by failing to register the Company or the Subsidiary under the Investment Company Act and by relying on case law that holds that commodities do not constitute securities for purposes of that Act.

Explanation of the Bill

Definition of foreign investment company

The bill would supplement the definition of "foreign investment company" (sec. 1246), on sales of shares of which U.S. persons treat gain as ordinary rather than capital. A foreign investment company would include any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly or indirectly by U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. The main effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The bill would generally not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—This provision would apply to sales and exchanges (and distributions) on or after May 23, 1983.

Extension of accumulated earnings tax to U.S.-owned foreign corporations

The bill would make it clear that U.S. persons could not use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings. For purposes of the accumulated earnings tax rules (secs. 531-537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned[1] foreign corporation out of those earn-

[1] The printed bill indicates this treatment for a "United States or foreign corporation." This reference in the printed bill is a typographical error.

ings and profits would be treated as derived by the receiving corporation from sources within the United States. That is, the earnings retain their U.S. source or U.S. connection in the hands of the receiving (upper-tier) corporation, so the accumulated earnings tax can apply to it.

The bill defines the term "United States-owned foreign corporation" to mean any corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. The bill would apply only to foreign corporations. It would apply to closely held and publicly held foreign corporations alike.

Effective date.—This provision would apply to distributions received by a United States-owned foreign corporation on or after May 23, 1983.

Treatment of offsetting position stock

The bill would expand the definition of personal property, for purposes of the straddle rules (sec. 1092), to include offsetting position stock. It would define offsetting position stock to mean any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders. This rule would apply to both U.S. and foreign corporations. Therefore, a taxpayer would be required to defer losses if offsetting position stock contained unrealized gains for him or her.

Effective date.—This provision would apply to positions established after May 23, 1983.

Effective Date

The effective dates for the provisions of the bill are included above in the "Explanation of the Bill."

Revenue Effect

The revenue effect of this bill is not available at this time.

6. H.R. 3173—Mr. Matsui

Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements under Money Purchase Pension Plans

Present Law

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, and losses. Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed by the employer to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July, 1978.) Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan by the employer due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Act of 1974 (ERISA) provided that the tax treatment of contributions to cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974, was to be governed under the law as it was applied prior to January 1, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the tax-qualification rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Explanation of the Bill

The bill would revise the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27, 1974, and which provided for a salary reduction arrangement on that date, to continue the arrangement after 1979. However, the revision to the tax-qualification rules would apply only to those money purchase pension plans under which employer and employee contributions may not exceed the limits (*e.g.*, the percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1979, a salary reduction arrangement under a money purchase pension plan must meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Revenue Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules presently apply to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

The provisions of the bill would apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

Effective Date

The bill would apply retroactively for plan years beginning after December 31, 1980, and to contributions made after that date. A transition rule would be provided for contributions made after 1979, and before the beginning of the first plan year beginning after 1980.

Revenue Effect

It is estimated that the bill would have a negligible effect on budget receipts.

Prior Congressional Actions

An identical bill, H.R. 4948, passed the House in the 97th Congress and was included as a committee amendment to H.R. 4577 as ordered reported by the Senate Committee on Finance. H.R. 4577 was not approved by the Senate.

7. H.R. 3592—Mr. Rostenkowski and Mr. Conable

Rollover of Certain Partial Distributions from Qualifed Plans and for other purposes

a. Rollover of certain partial distributions from qualified plans (sec. 2 of the bill and sec. 402(a) of the Code)

Present Law

Under present law, an employee's benefits from or under a tax-qualified pension, profit-sharing, stock bonus plan, or a qualifed annuity plan generally are includible in income when the benefits are distributed. If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension, etc., plan or an individual retirement account, annuity, or retirement bond (an IRA). If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution.

Present law defines a qualifying rollover distribution as one or more distributions (1) within one taxable year of the employee on account of the termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under the plan, (2) that constitute a lump-sum distribution, or (3) that constitute a distribution of accumulated deductible employee contributions.

Similar rules apply under present law to benefits under tax-sheltered annuity contracts. Consequently, a lump-sum distribution under a tax-sheltered annuity contract also may be rolled-over, tax-free, to another tax-sheltered annuity contract or to an IRA. Tax-sheltered annuity contracts may be purchased for employees by certain tax-exempt organizations or by public educational organizations.

A distribution is a lump-sum distribution only if it consists of the balance to the credit of the employee under the qualified pension, etc., plan or tax-sheltered annuity contract, is made within one taxable year of the recipient, and is made on account of the employee's attainment of age 59 1/2, separation from service, or death. In the case of a self-employed individual, a lump-sum distribution may be paid on account of attainment of age 59 1/2, death, or disability.

If an employer maintains more than one qualified pension, etc., plan, present law requires that all qualified pension, etc., plans of the employer of the same type (*e.g.*, all profit-sharing plans) generally must be aggregated for purposes of determining whether the balance to the credit of the employee has been distributed in a lump sum distribution. A special exception applies solely for purposes of the rollover provisions. Consequently, if an employer maintains two qualified pension plans, one of which is a defined benefit pension plan and one of which is a money purchase pension plan, and the balance to the credit of an employee in the money purchase pension plan is distributed, the balance to the credit of the employee under the defined benefit pension plan is not counted under the aggregation rules. In the case of a tax-sheltered annuity contract, the aggregation rules provide that all tax-sheltered annuity contracts purchased for an employee by one employer are treated as a single contract for purposes of determining the balance to the credit of the employee.

Under present law, if no part of a lump sum distribution from a qualified pension, etc., plan is rolled over, it may be accorded special 10-year income averaging.[1] Also, present law provides that if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged. This rule applies whether or not all or a portion of the distribution is rolled over to another qualified plan or to an IRA.

Explanation of the Provision

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, etc., plan, qualified annuity plan, or a tax-sheltered annuity contract could be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution would be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified pension, etc., plan or a tax-sheltered annuity contract, amounts credited under other qualified plans or tax-sheltered annuity contracts of the same employer are not counted.

As under present law, the rollover of a partial distribution must be made within 60 days after the date of the distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified pension, etc., plan or a tax-sheltered annuity. In addition, any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) would not be eligible for the special 10-year income averaging, or long-term capital gain treatment accorded lump sum distributions and no special treatment would be accorded to net unrealized appreciation of employer securities. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distri-

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[1] Alternatively, a part of the distribution may be accorded long-term capital gain treatment. Long-term capital gain treatment also may be available with respect to a qualifying rollover distribution under a qualified annuity plan or a tax-sheltered annuity contract.

bution under any other tax-sheltered annuity of the same employer would not be eligible for long-term capital gains treatment.

In the case of a rollover of a partial distribution, the maximum amount rolled over could not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs could not be rolled over to a qualified pension, etc., plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

Effective Date

The provision would be effective for distributions made after December 31, 1983, in taxable years ending after that date.

Revenue Effect

It is estimated that the bill would have a negligible effect on budget receipts.

b. Treatment of certain transactions between related parties (secs. 3 and 4 of the bill and sec. 267 of the Code)

Present Law

Under present law, an accrual-basis taxpayer is denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 267). The disallowed interest and business expenses are those which are not paid to the related person within the taxable year in which the expenses accrue or within 2-1/2 months thereafter. This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

Present law places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owns at least two percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of a subchapter S corporation are taken into account on the shareholders' returns) are allowed at the same time the income is recognized by the shareholder. Furthermore, no deductions are lost if payment is made after the 2-1/2-month period expires. Present law does not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present law requires that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c)) (an accural rule).

Finally, present law provides that no deduction is allowed for losses from sales or exchanges of property between related parties. Any gain recognized on a subsequent disposition of the property by the related party is reduced by the disallowed loss.

Explanation of Provision

Under the bill, an accrual-basis taxpayer would be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer. Thus, the accrual-basis taxpayer would be allowed to deduct business expenses or interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2-1/2 months after the close of the taxable year); in other words, the deduction by the payor would be allowed only when the corresponding income is recognized by the payee.

Also, the present-law special rules relating to payments by subchapter S corporations would be extended to payments by partnerships. Thus, a partnership would not be allowed to deduct accrued business expenses or interest owed to a partner until the amounts are paid and are includible in the income of the cash-basis partner. This rule would apply to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)(A)). This cash basis rule would not apply, however, to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued. [2]

For example, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the bill, unpaid interest owed by X to Y cannot be deducted by X until paid to Y, because Y is related to a partner of X by reason of section 707(b)(1)(A). If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1)(A), then the new rule would not apply.

Finally, the bill would extend the loss disallowance and accrual provisions of section 267 to transactions between certain controlled corporations. For purposes of these loss disallowance and accrual provisions, corporations would be treated as related persons under the controlled corporation rules of section 1563, except that a 50-percent control test would be substituted for the 80-percent test.

Effective Date

The bill would apply to taxable years beginning after December 31, 1983.

Revenue Effect

The revenue effect of this bill is not available at this time.

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[2] Although the language of of the bill excepts all amounts to which sec. 706(a) applies, that exception was intended to refer only to the application of sec. 706(a) to guaranteed payments.

c. Preferred stock eligible for small business corporation stock treatment (sec. 5 of the bill and sec. 1244 of the Code)

Present Law

Under present law, gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is generally treated as capital gain or loss. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to $3,000 of ordinary income.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders to whom the stock was originally issued, and to individuals who are partners in a partnership at the time the partnership acquired the stock from an issuing small business corporation and who share in a loss sustained by the partnership on the section 1244 stock.

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $50,000 ($100,000 in the case of married taxpayers filing a joint return).

For stock to qualify as section 1244 stock, the following requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must be a domestic corporation; (3) the equity capital of the corporation may not exceed $1,000,000; (4) the stock must be issued for money or other property, subject to certain exceptions; and (5) the corporation must be engaged in the active conduct of a trade or business.

Explanation of Provision

Under the bill, the ordinary loss provisions of section 1244 would be extended to losses on preferred stock of small business corporations. All restrictions applicable under present law to losses on common stock would apply to losses on preferred stock. This provision is intended to encourage the investment of new venture capital in small, high-risk corporate ventures.

Effective Date

The provision would apply to stock issued after the date of enactment.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less thn $5 million annually.

Prior Congressonal Action

A similar provision was reported by the Ways and Means Committee in the 97th Congress as part of "The Tax Incentive Act of 1981" (H.R. 4242), but which was not approved by the House.

d. Coordination of certain amendments made by the Highway Revenue Act of 1982 and Public Law 97-473 (sec. 6 of the bill)

Present Law

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax exempt under section 103 and that therefore the shareholders of regulated investment companies holding those obligations qualify for tax-free treatment on the distributions of the interest on those obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to P.L. 97-473, the question arises whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

Explanation of Provision

The bill would clarify that Public Law 97-473 did not repeal the provision relating to tax-exempt interest added by the Highway Revenue Act.[3]

Effective Date

The provision would be effective upon enactment.

Revenue Effect

The provision would not affect revenues.

[3] An identical provision is included in H.R. 3805, the Technical Corrections Act of 1983, introduced by Chairman Rostenkowski. A hearing is scheduled on H.R. 3805 by the Committee on Ways and Means on September 22, 1983.

8. H.R. 3593—Messrs. Stark and Conable

Medical Care Deduction Allowed For Lodging Away from Home

Present Law

As a general rule, individuals who itemize deductions may deduct expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or a dependent, to the extent that such expenses exceed 5 percent of adjusted gross income (Code Sec. 213). The term medical care is defined to include amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance covering medical care. The primary rationale for allowing an itemized deduction for medical expenses is that "extraordinary" medical costs reflect an economic hardship, beyond the taxpayer's control, which reduces the taxpayer's ability to pay Federal income tax.

Explanation of the Bill

Under the bill, the definition of medical care provided in section 213(d) would be broadened to include amounts paid for lodging while away from home under circumstances in which such lodging is primarily for and essential to medical care provided by a physician in (1) a licensed hospital or (2) a nationally or regionally recognized medical care facility. The deduction would not be allowed for amounts paid for lodging that is lavish or extravagant under the circumstances. Further, no deduction would be allowed if there is a significant element of personal pleasure, recreation, or vacation in the travel away from home.

Effective Date

The provisions of the bill would apply to taxable years beginning after December 31, 1983.

Revenue Effect

The revenue effect of this bill is not available at this time.

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