[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 146, S. 1332, S. 1758, S. 1809, and S. 1857)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON NOVEMBER 17, 1983

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on November 17, 1983, before the Senate Finance Subcommittee on Taxation and Debt Management.

The five bills scheduled for the hearing, in the order in which the bills are listed in the press release announcing the hearing, are S. 1332 (relating to investment tax credit for certain vessels acquired with funds withdrawn from a capital construction fund); S. 146 (permanent exemption from FUTA tax for wages of certain fishing boat crew members); S. 1809 (exception for regulated investment companies from definition of personal holding company); S. 1857 (conform charitable deduction rules for private nonoperating foundations and public charities; amendments to foundation excise tax provisions); and S. 1758 (simplified cost recovery system for personal property).

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, and effective dates.

I. SUMMARY

1. S. 1332—Senator Mitchell

Investment Tax Credit for Certain Vessels Acquired With Funds Withdrawn from a Capital Construction Fund

Present law provides that taxable income is reduced by amounts equal to certain amounts deposited in a capital construction fund established under section 21 of the Merchant Marine Act of 1970 (46 U.S.C. sec. 1177(d)). When withdrawn from the fund, such amounts are generally taxable unless used to acquire, construct, or reconstruct a qualified vessel. If used to acquire, construct, or reconstruct a qualified vessel, such amounts are not taxable; however, the taxpayer's basis in the vessel is reduced to reflect the fact that the taxpayer had previously deducted those amounts.

Present law also generally provides that the amount of investment tax credit allowable with respect to new property eligible for the credit is determined with reference to the basis in such property. For investment credit purposes, the basis of a qualified vessel financed in whole or in part with previously deducted funds withdrawn from a capital construction fund is not to be reduced by more than 50 percent of the amount of previously deducted funds so withdrawn (Code sec. 46(g)).

The bill would provide that for investment credit purposes, the basis of a qualified vessel financed in whole or in part with previously deducted funds withdrawn from a capital construction fund is not to be reduced by any portion of the previously deducted funds so withdrawn. Thus, no investment credit otherwise available would be lost. The bill would be effective for taxable years beginning after 1982.

2. S. 146—Senators Mitchell, Cohen, Mathias, Heflin, and Sarbanes

Permanent Exemption from FUTA Tax for Wages of Certain Fishing Boat Crew Members

Prior to the Economic Recovery Tax Act of 1981, remuneration paid to fishing boat crew members who were considered self-employed for social security tax purposes, and whose remuneration therefore was exempt from the tax imposed by the Federal Insurance Contributions Act (FICA) and from income tax withholding, was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons.

The Economic Recovery Tax Act of 1981, as amended by the Miscellaneous Revenue Act of 1982, amended the definition of employment for purposes of FUTA taxes to exempt remuneration paid during 1981 and 1982 to fishing boat crew members who were treated as self-employed for purposes of social security taxes.

The bill would have the effect of making permanent this exemption from FUTA taxes for taxable years beginning after 1982.

3. S. 1809—Senator Baucus

Exception for Regulated Investment Companies from Definition of Personal Holding Company

Under present law, a corporation is treated as a personal holding company if, among other requirements, at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for no more than five individuals (Code secs. 541-547). For this purpose, an individual is considered as owning the stock owned, directly or indirectly, by or for members of his or her family, or by or for a partner of the individual. A personal holding company cannot qualify as a regulated investment company.

Under the bill, an investment company would not be treated as a personal holding company if certain stock ownership tests are met. Further, for purposes of applying such tests, stock owned, directly or indirectly, by or for an individual would not be attributed to such individual's partners in a limited partnership.

4. S. 1857—Senators Durenberger, Moynihan, Bradley, Matsunaga, Lugar, Packwood, and Tsongas

Conform Charitable Deduction Rules for Private Nonoperating Foundations and Public Charities; Amendments to Foundation Excise Tax Provisions

Charitable deduction rules

The bill would conform the tax treatment of contributions by individuals to private nonoperating (grantmaking) foundations to that provided under present law for contributions by individuals to public charities or private operating foundations (Code sec. 170), effective for contributions made after 1982. As a result, contributions of cash or ordinary-income property would be deductible up to 50 percent of the donor's adjusted gross income, and contributions of capital-gain property, up to 30 percent; excess contributions could be carried forward for five years; and the full fair market value of donated capital-gain property would be deductible.

Definition of family members

Present law contains a number of restrictions imposed on private foundations which depend on determinations of "disqualified persons." This term includes a substantial contributor, a foundation manager, or a member of the family of such individuals (sec. 4946). A member of the family includes the spouse, ancestors, and lineal descendants (and spouses of lineal descendants) of the individual.

The bill would narrow the category of disqualified persons by limiting family members to the spouse, ancestors, children, and grandchildren (and the spouses of children and grandchildren) of the substantial contributor, etc., effective January 1, 1983.

Reliance on IRS classification of donee organization

Under present law, Treasury regulations and IRS rulings establish guidelines under which a private foundation may rely on an IRS classification of a donee organization as a public charity or private operating foundation.

The bill would provide that a grant (made after 1982) to an organization which the IRS has determined to be a public charity (or private operating foundation) would be treated as a grant to such an organization, even though the donee organization loses such status, if (1) the grant was made prior to the earlier of the date of publication by the IRS that the donee organization has lost its qualified status, or the date on which the foundation acquires actual knowledge that the donee organization has been notified by the IRS of loss of its qualified status, and (2) the donor foundation was not responsible for (other than by making grants) or aware of the change in the donee's status.

Exemption from expenditure responsibility requirements

Under present law, a private foundation must exercise "expenditure responsibility" over grants to organizations other than public charities. In order to ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the IRS on the grants (sec. 4945(h)).

The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant (made after 1982) to an organization if the aggregate amount of grants made during the taxable year by the foundation (and all related foundations) to that organization does not exceed $25,000.

Abatement of first-tier excise taxes

Under present law, any violation of the foundation rules results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). In general, this first-tier tax applies automatically when a foundation rule is violated.

The bill would waive the first-tier excise tax imposed under sections 4941-4945 on the foundation (or disqualified person, in the case of self-dealing) if the Internal Revenue Service determines that the violation (1) was due to reasonable cause and not to intentional disregard of rules and regulations, and (2) the violation is "corrected" with the specified period. This provision would apply to post-1982 taxable years.

5. S. 1758—Senators Bentsen, Wallop, Symms, Bradley, Grassley, Mitchell, Durenberger, Baucus, Matsunaga, and Roth

Simplified Cost Recovery System for Personal Property

Present law

Under present law, the cost of most tangible personal property (other than long-lived public utility property) placed in service after 1980 may be written off over 3 years or 5 years under the Accelerated Cost Recovery System (ACRS). Recovery schedules are provided which approximate the benefits of using the 150-percent declining balance method in the early years and the straight-line method in later years. Unless the taxpayer elects a reduced investment tax credit for the property, the cost that may be written off is decreased by one-half the amount of the credit for which the property qualifies.

Recovery of progress expenditures made during the period of construction does not begin until the property is placed in service. Gain from the disposition of personal property is recaptured as ordinary income to the extent of prior recovery deductions taken. For purposes of earnings and profits, depreciation of property in the 3-year or 5-year classes is generally computed by using the straight-line method over 5 and 12 years, respectively.

S. 1758

Under the bill, an open-ended accounting method of cost recovery would apply to property (other than public utility property) that is placed in service after 1982 and is treated under present ACRS rules as 3-year or 5-year property. The present basis adjustment (and the reduced credits which apply in lieu of basis adjustment) would be repealed for property subject to the new system.

Cost recovery for qualified progress expenditures made after 1985 would start when the expenditures are made, if the asset would be depreciated under the new system when placed in service. The new system would generally eliminate determination of gain and recapture on the disposition of assets and would modify the computation of depreciation for earnings and profits.

II. DESCRIPTION OF THE BILLS

1. S. 1332—Senator Mitchell

Investment Tax Credit for Certain Vessels Acquired With Funds Withdrawn from a Capital Contribution Fund

Present Law

The Merchant Marine Act of 1970

The Merchant Marine Act of 1970, as amended (the Act), provides certain Federal income tax incentives for U.S. taxpayers owning or leasing vessels operating in the foreign or domestic commerce of the U.S. or in U.S. fisheries (46 U.S.C. sec. 1177(d)).

In general, such taxpayers are entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. Furthermore, earnings from the investment or reinvestment of amounts in such a fund are excluded from income. The purpose of these provisions is to provide a tax inducement to aid the U.S. shipping and shipbuilding industries.

A nonqualified withdrawal of previously deducted or excluded monies by a taxpayer from a fund will generate income to the taxpayer. However, a qualified withdrawal will not. A qualified withdrawal is a withdrawal, made in accordance with the terms of the applicable agreement, which is for the acquisition, construction, or reconstruction of a qualified vessel or for the payment of principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of such a vessel. A qualified vessel is a vessel (including barges and containers which are part of the complement therefor) constructed or reconstructed in the U.S. and documented under U.S. laws which is to be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries.

Cost recovery

Since the Act provides for the deduction (or exclusion) of certain amounts deposited in a capital construction fund and their tax-free withdrawal in the case of a qualified withdrawal, the Act also requires a reduction in the tax basis of the qualified vessel in an amount based on the amount of funds withdrawn. Without that rule, a taxpayer would be entitled to cost recovery deductions with respect to amounts the taxpayer had already deducted from (or never included in) income. The purpose of that rule, then, is to prevent double deductions.

Investment tax credit

In general, the amount of investment tax credit for eligible new property (new section 38 property) is determined with reference to the basis of such property to the taxpayer (Code sec. 46(c)(1)(A)). Under Treasury regulations, if the basis of new section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then the investment credit is recaptured (Treas. Reg. sec. 1.47-2(a)(1)).

Prior to 1976, the law made no explicit provision for the effect of the Act's basis reduction rules on the amount of investment credit to be allowed with respect to a qualified vessel constituting new section 38 property which was financed in whole or in part by qualified withdrawals from a capital construction fund. The Internal Revenue Service has ruled that the investment credit should be determined with reference to the property's basis after the reduction required by the Act (Rev. Rul. 67-395, 1967-2 C.B. 11).

Two courts have addressed the issue. The U.S. Tax Court has agreed with the Internal Revenue Service (*Zuanich* v. *Commissioner*, 77 T.C. 428 (1981)). However, the U.S. Court of Claims (now the Claims Court) has disagreed, holding on several occasions that the fact that the cost of a qualified vessel was financed in whole or in part by previously deducted or excluded funds withdrawn from a capital construction fund has no effect on the investment credit to be allowed (see, e.g., *Oglebay Norton Company* v. *United States*, 79-2 USTC para. 9705 (1979); and *Pacific Far East Line, Inc.* v. *United States*, 76-2 USTC para. 9718 (1976)). Based on the foregoing, taxpayers facing the issue generally seek to litigate it in the Claims Court.

The Internal Revenue Service has also ruled that a qualified withdrawal of previously deducted or excluded funds used to pay a principal amount on mortgage indebtedness incurred to purchase a qualified vessel should be treated as reducing basis for investment credit purposes and triggering investment credit recapture under Treas. Reg. sec. 1.47-2(a)(1) (see, e.g., Rev. Rul. 68-468, 1968-2 C.B. 26).

The Tax Reform Act of 1976 provided, only for purposes of determining the investment credit, that basis is to be reduced by not more than 50 percent of the amount of a qualified withdrawal of previously deducted or excluded funds (sec. 46(g)). That rule was made applicable with respect to investment credits claimed in years beginning after 1975. However, section 46(g)(3) and its legislative history make it clear that the new rule established only a floor for, and not a ceiling on, the amount of basis which a qualified vessel would be treated as having for investment credit purposes. In other words, after the Tax Reform Act of 1976, a taxpayer could seek to establish that no investment credit should be lost merely because a qualified withdrawal of previously deducted or excluded funds had been used in financing the acquisition, construction, or reconstruction of a qualified vessel (see *Zuanich* v. *Commissioner*, *supra*).

The Tax Equity and Fiscal Responsibility Act of 1982 generally provided that for cost recovery purposes, the basis of property is to be reduced by 50 percent of any investment credit allowed (sec.

48(q)). An election to reduce allowable investment credit in lieu of reducing basis for cost recovery purposes is available. Present law is not explicit as to how this basis reduction rule applies in a case where a qualified vessel is financed by means of a qualified withdrawal of previously deducted or excluded funds, particularly if the vessel is financed entirely by means of such a withdrawal. In the latter case, the vessel would have no basis for cost recovery purposes to reduce.

Issues

The cost recovery and investment tax credit rules enacted in the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 together provide tax benefits for investments in equity-financed depreciable personal property approximately the equivalent of current expensing of the cost of that property. Those rules include provisions which require that a taxpayer elect either to reduce the basis of property for cost recovery purposes by one-half the amount of investment credit taken or reduce the investment credit with respect to such property (sec. 48(q)).

Disregarding investment credits, the present-law rules applicable to certain deposits into a capital construction fund provide tax benefits in excess of those which would be allowed under a system permitting current expensing of that portion of the cost of a qualified vessel financed by means of a qualified withdrawal. That result occurs because funds ultimately to be used in acquiring, constructing, or reconstructing a qualified vessel, a depreciable asset, are deductible (or excludable) before the vessel is placed in service, perhaps even before any contract to acquire, construct, or reconstruct such a vessel is entered into. To the extent any investment credit is allowed with respect to a qualified withdrawal of previously deducted or excluded funds, the tax benefits increase. Finally, to the extent a full investment credit is allowed without any adjustment in basis for cost recovery purposes of the type provided for by section 48(q), the available tax benefits continue to improve.

On the other hand, the Congress over the years has evidenced a policy of providing tax incentives to the domestic shipping and shipbuilding industries. The Merchant Marine Acts and section 46(g) of the Tax Reform Act of 1976 illustrate the point. The bill would provide further support for those industries by codifying the line of cases from the Court of Claims permitting a full investment credit.

The principal issues are whether tax incentives for the domestic shipping and shipbuilding industries should be statutorily increased and, if so, by what amount.

Explanation of the Bill

Initial financing

The bill would provide that no investment credit with respect to a qualified vessel is to be unavailable merely because all or part of the cost of the acquisition, construction, or reconstruction of such a vessel is financed by any deposit in or qualified withdrawal of previously deducted or excluded amounts from a capital construction fund under the Act (sec. 46(g)). Thus, the bill would overturn the holdings in Rev. Rul. 67-395 and *Zuanich* v. *Commissioner, supra.* The bill would make no special provision for adjusting basis for cost recovery purposes.

Payment of principal amount on mortgage indebtedness

The bill would also provide that using funds received in a qualified withdrawal of previously deducted or excluded amounts to pay down principal on indebtedness secured by a mortgage on a qualified vessel is not to give rise to any investment credit recapture.[1] Thus, the bill would also overturn the ruling in Rev. Rul. 68-468, *supra.*

Effective Date

The bill would be effective for taxable years beginning after December 31, 1982, and to investment credits allowed for such taxable years.

[1] Technical corrections would be needed to the bill's references to section 167 and to actual useful life.

2. 146—Senators Mitchell, Cohen, Mathias, Heflin, and Sarbanes

Permanent Exemption from FUTA for Wages of Certain Fishing Boat Crew Members

Present Law

For purposes of social security taxes and income tax withholding, members of the crews on boats in a fishing operation engaged in catching fish or other forms of aquatic animal life are considered to be self-employed if (1) their remuneration is a share of the boats' catch (or cash proceeds from the sale of a share of the catch, and no other cash remuneration is provided), (2) their share depends on the amount of the boats' catch, and (3) if the crew of each boat normally is made up of fewer than ten individuals. If these requirements are met, remuneration paid to these crew members is exempt from the Federal Insurance Contributions Act (FICA) tax and income tax withholding, and is subject to the Self-Employment Contributions Act tax (Code secs. 3121(b)(20), 3401(a)(17), and 1402(c)(2)(F)).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), remuneration paid to fishing boat crew members was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons (sec. 3306(c)(17)).

Section 822 of ERTA amended the definition of employment for purposes of FUTA taxes to exempt from FUTA taxes remuneration paid during 1981 to fishing boat crew members who were treated as self-employed for social security tax purposes and were thus exempt from FICA. The exemption from FUTA taxes was limited to 1981, to give the Congress an opportunity (1) to determine the best long-term solution to the problem of fishing boat crew members who are treated as self-employed for purposes of social security and income tax withholding, but who are not treated as self-employed for purposes of the unemployment tax provisions, and (2) to make certain that no fishing boat crew members would be adversely affected. Section 203 of the Miscellaneous Revenue Act of 1982 (P.L. 97-362) amended ERTA to provide that the exemption from FUTA taxes was effective for remuneration paid in 1981 and 1982.

Explanation of the Bill

The bill would provide that, notwithstanding any other provisions of law, the definition of employment and the exclusions from that definition for purposes of FUTA, as amended by section 822 of ERTA and section 203 of the Miscellaneous Revenue Act of 1982, are effective with respect to taxable years beginning after 1982.

Thus, the bill would make permanent the present FUTA tax exemption for remuneration paid to fishing boat crew members who are treated as self-employed and thus are exempt from FICA.

Effective Date

The bill would be effective upon enactment.

3. S. 1809—Senator Baucus

Exception for Regulated Investment Companies From Definition of Personal Holding Company

Present Law

Under present law, a 50-percent tax is imposed each year on the undistributed personal holding company income of a personal holding company (Code secs. 541-547). A corporation is treated as a personal holding company if (1) at least 60 percent of its adjusted ordinary gross income for the taxable year consists of personal holding company income (dividends, interest, rents, royalties, and certain other passive income), and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For this purpose, an individual is considered as owning the stock owned, directly or indirectly, by or for members of his or her family, or by or for a partner of the individual.

Under present law, certain corporations are excepted from the definition of a personal holding company. The excepted corporations include tax-exempt organizations, banks, domestic building and loan associations, life insurance companies, surety companies, foreign personal holding companies, lending or finance companies meeting certain active business and gross income tests, foreign corporations with no domestic shareholders, small business investment companies licensed by the Small Business Administration, and corporations subject to the jurisdiction of a bankruptcy court.

A regulated investment company ("RIC"), generally speaking, is a domestic corporation (other than a personal holding company) that issues shares to investors and invests the proceeds in securities. Regulated investment companies are generally treated as conduits for Federal income tax purposes (secs. 851-855).

Explanation of the Bill

Because of the attribution rule described above, under present law an investment company may be treated as a personal holding company, and fail to qualify as a RIC, if the shareholders of the investment company own limited partnership interests in the same partnership. Under the bill, a RIC would not be treated as a personal holding company if, at all times during the second half of the taxable year, (1) the company has at least 100 shareholders that are individuals or are treated as individuals, and (2) not more than 50 percent in value of the company's outstanding stock is owned, directly or indirectly, by or for five or less individuals. Further, for purposes of the rule attributing to an individual stock owned, directly or indirectly, by or for a partner of the individual, the term partner would not include any limited partners.

Effective Date

The amendments made by the bill would apply with respect to taxable years ending on or after the date of enactment.

4. S. 1857—Senators Durenberger, Moynihan, Bradley, Matsunaga, Lugar, Packwood, and Tsongas

Conform Charitable Deduction Rules for Private Nonoperating Foundations and Public Charities; Amendments to Foundation Excise Tax Provisions

a. Charitable deduction rules

Present law

In general.—Present law generally provides more favorable income tax treatment for contributions by individuals to public charities or private operating foundations than for such contributions to private nonoperating (grantmaking) foundations (Code sec. 170).

Percentage limitations.—For contributions of cash or ordinary-income property to public charities or operating foundations, the maximum amount which an individual may deduct in one year is 50 percent of his or her adjusted gross income. The 50-percent limitation applies to contributions to private nonoperating foundations only if the donees either redistribute all contributions within a specified period after receipt or qualify as a "pooled fund" foundation. For contributions of capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of contributions to private nonoperating foundations other than the two categories eligible for the 50-percent/30-percent limitations, and for certain other charitable contributions, the limitation is 20 percent (for contributions of cash or property).

Carryover.—Amounts in excess of the 50-percent/30-percent limitations may be carried forward and deducted over the following five years (subject to applicable percentage limitations in those years). Under present law, there is no carryover of excess deduction amounts where the 20-percent limitation applies.

Appreciated property.—In the case of donations by individuals of capital-gain property to private nonoperating foundations where the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation, i.e., by 40 percent of the amount by which the value exceeds the donor's basis in the property. In the case of donations by individuals of capital-gain property to public charities, etc., where the 30-percent limitation applies, there is no reduction from fair market value (except with respect to donated tangible personal property if use by the donee of the property is unrelated to the donee's tax-exempt purposes).

Explanation of provision

Section 1 of the bill would provide the same charitable deduction rules for contributions by individuals to all private nonoperating foundations as now apply for contributions to public charities and private operating foundations. Thus, the 50-percent/30-percent limitations would apply instead of the 20-percent limitation, any contribution amounts exceeding the limitations could be carried forward five years, and the full fair market value of donated capital-gain property generally could be deducted.

The amendments made by section 1 of the bill would apply to taxable years beginning after 1982.

b. Narrowing of definition of family members

Present law

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." A "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager (sec. 4946). For this purpose, a member of the family includes the spouse, ancestors, and lineal descendants (and spouses of lineal descendants) of the individual.

Explanation of provision

Section 2(a) of the bill would narrow the category of "disqualified persons" by limiting family members to the spouse, ancestors, children, and grandchildren (and the spouses of children and grandchildren) of the substantial contributor, etc. The effect of this amendment would be to exclude from the definition of family member any lineal descendant who is more than two generations from the substantial contributor, etc.

The amendment made by section 2(a) of the bill would take effect on January 1, 1983.

c. Reliance on IRS classification of donee organization

Present law

The tax status of a donee organization as a public charity or private operating foundation is important to a donor private foundation because (1) foundation grants to operating foundations generally may be counted by the donor foundation as qualifying distributions in satisfaction of the section 4942 payout rules, while grants to nonoperating foundations do not so qualify (with certain exceptions); and (2) a donor foundation must exercise expenditure responsibility (sec. 4945) over grants to operating or nonoperating foundations, but not over grants to public charities.

Pursuant to Treasury regulations under section 4945, once an organization has been classified as publicly supported, the determination of whether a grant is subject to the expenditure responsibility requirements generally will not be affected by the donee's subsequent loss of classification as a publicly supported organization until notice of loss of classification is published.

However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-3(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization (Rev. Proc. 81-6, 1981-1 C.B. 620).[2] In addition, the Internal Revenue Service has published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported (Rev. Proc. 81-7, 1981-1 C.B. 621).[3]

Explanation of provision

Section 2(b) of the bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity (or private operating foundation) would be treated as a grant to such an organization, even though the donee organization loses such status, if (1) the grant was made prior to the earlier of the date of publication by the Service that the donee organization has lost its qualified status, or the date on which the foundation acquires actual knowledge that the donee organization has been notified by the Service of loss of its qualified status, and (2) the donor foundation was not responsible for (other than by making grants) or aware of the change in the donee's status.

The amendment made by section 2(b) of the bill would apply to grants made after 1982.

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[2] Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant. In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[3] Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses.

d. Exemption from expenditure responsibility requirements

Present law

To avoid imposition of excise taxes under Code section 4945, a private foundation must exercise "expenditure responsibility" over grants to organizations other than public charities. In order to ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants (sec. 4945(h)). There is no exception in present law from the expenditure responsibility requirements for grants below a specified dollar amount.

Explanation of provision

Section 2(c) of the bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the taxable year by the foundation (and all related foundations) to that organization does not exceed $25,000. This exemption would apply to grants made after 1982.

e. Abatement of first-tier excise taxes

Present law

The Tax Reform Act of 1969 established a two-tier system of excise taxes intended to ensure compliance with the private foundation rules set forth in Code sections 4941-4945.

Under present law, any violation of the foundation rules results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). In general, this first-tier tax applies automatically when a foundation rule is violated, even if the violation in a particular instance could be deemed inadvertent. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If a violation of the foundation rules is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person).

Explanation of provision

Section 2(d) of the bill would waive the first-tier excise tax imposed under sections 4941-4945 on the foundation (or disqualified person, in the case of self-dealing) if the Internal Revenue Service determines that the violation (1) was due to reasonable cause and not to intentional disregard of rules and regulations, and (2) the violation is "corrected" with the specified period.

The amendments made by section 2(d) of the bill would apply to taxable years beginning after 1982.

5. S. 1758—Senators Bentsen, Wallop, Symms, Bradley, Grassley, Mitchell, Durenberger, Baucus, Matsunaga, and Roth

Simplified Cost Recovery System for Personal Property

Present Law

Overview

The cost of most tangible personal property (other than long-lived public utility property) placed in service after 1980 may be written off over 3 years or 5 years under the Accelerated Cost Recovery System (ACRS). Recovery schedules are provided which approximate the benefits of using the 150-percent declining balance method in the early years and the straight-line method in later years. Unless the taxpayer elects a reduced investment tax credit for the property, the cost that may be written off is decreased by one-half the amount of the credit for which the property qualifies.

Recovery of progress expenditures made during the period of construction does not begin until the property is placed in service. Gain from the disposition of personal property is recaptured as ordinary income to the extent of prior recovery deductions taken. For purposes of earnings and profits, depreciation of property in the 3-year or 5-year classes is generally computed by using the straight-line method over 5 and 12 years, respectively.

Cost recovery under ACRS

General rules

The cost of most tangible personal property placed in service after 1980 is written off under ACRS (Code sec. 168). Under ACRS, each item of personal property is assigned to one of four recovery classes. For each class, ACRS provides both a recovery period, the number of years over which costs may be written off, and a schedule of recovery percentages.

The recovery percentages approximate the benefits of using the 150-percent declining balance method (with a half-year convention) in the early years of the recovery period and the straight-line method in the later years. The recovery deduction for an asset is computed by multiplying the cost of the property times the appropriate recovery percentage. For this purpose, cost is first decreased by one-half the amount of investment credit for the property ("basis adjustment"), unless the taxpayer elects to take a reduced credit (sec. 48(q)).

Present law provides certain options for, and restrictions on, the use of ACRS as it is summarized above.

3-year property

Automobiles, light-duty trucks, certain special tools, personal property used in connection with research and experimentation, and other short-lived property are assigned to the 3-year class. The recovery period for this class is 3 years, and recovery percentages are 25 percent for the first year, 38 percent for the second year, and 37 percent for the third year. The investment credit for qualifying property in the 3-year class is 6 percent, unless the taxpayer elects a 4-percent credit in lieu of basis adjustment.

To illustrate the operation of ACRS and basis reduction for assets in the 3-year class, assume that a calendar-year taxpayer places a $100 asset in service in 1983 and that the asset qualifies for the investment credit. The amount of the credit would be $6, available in 1983. The basis adjustment would be $3, which leaves $97 to be recovered. If the taxpayer continues to use the asset at least through 1985, recovery deductions would be $24.25 for 1983, $36.86 for 1984, and $35.89 for 1985.

5-year property

Personal property which is not in the 3-year class and is not long-lived public utility property is, with certain limited exceptions, assigned to the 5-year class. (Long-lived public utility property is assigned to the 10-year class or 15-year public utility class under ACRS.) Also, certain single-purpose agricultural and horticultural structures and certain petroleum storage facilities are included in the 5-year class.

The recovery period for property in this class is 5 years, and the recovery percentages are 15 percent for the first year, 22 percent for the second year, and 21 percent for each of the three following years. The investment credit for qualifying property in the 5-year class is 10 percent, unless the taxpayer elects an 8-percent credit in lieu of basis adjustment.

Progress expenditures

Generally, investment credits are claimed for the taxable year in which qualifying property was placed in service. However, in certain cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction before the property is completed and placed in service (sec. 46(d)). In any case, cost recovery of progress expenditures does not begin until the property is placed in service.

Disposition of assets and recapture

Gain or loss is generally recognized on each disposition of an asset, including retirements from service, unless other provisions of the Code provide for nonrecognition. Gain from the disposition of depreciable personal property is recaptured as ordinary income to the extent of prior recovery deductions taken for the property (sec. 1245). For this purpose, the amount of any basis adjustment for investment credits is treated as a cost recovery deduction. Gain in excess of recovery deductions taken may be treated as a capital gain under section 1231 (unless the gain is offset by losses on sec. 1231 assets).

Earnings and profits

A corporate distribution with respect to the corporation's stock is generally taxable as a dividend only if it is made out of the corporation's current or accumulated earnings and profits. The computation of earnings and profits is similar to the computation of taxable income, as modified by certain adjustments and special rules.

Under one of these special rules, depreciation for earnings and profits is generally computed by using the straight-line method over 5 years for 3-year property and over 12 years for 5-year property (sec. 312(k)).

Explanation of the Bill

Overview

Under the bill, an open-ended accounting method of cost recovery would apply to property (other than public utility property) that is placed in service after 1982 and is treated under present ACRS rules as 3-year or 5-year property. The present basis adjustment (and the reduced credits which apply in lieu of basis adjustment) would be repealed for property subject to the new system.

Cost recovery for qualified progress expenditures made after 1985 would start when the expenditures are made, if the asset would be depreciated under the new system when placed in service. The new system would generally eliminate determination of gain and recapture on the disposition of assets and would modify the computation of depreciation for earnings and profits.

Cost recovery under open-ended accounts

General rules

In general, an open-ended accounting method of cost recovery would apply to property (referred to as post-1982 recovery property) that is placed in service after 1982 and is treated under present ACRS rules as 3-year or 5-year property. However, this recovery method would not apply to any public utility property, the costs of which would be recovered under present rules. The bill would repeal the present basis adjustment and the reduced investment credits in lieu of basis adjustment for post-1982 recovery property.

Post-1982 recovery property would be assigned to one of two categories (referred to as category 1 and category 2). For each category, there would be one open-ended recovery account and a recovery percentage selected, within limits, by the taxpayer.

Unlike current procedures under ACRS, where a separate account may be established for each item of property, the costs of all property in the same category would be placed in the same recovery account, regardless of the year of acquisition. This would be done according to a half-year convention, under which one-half the cost of an asset is added in the taxable year it is placed in service and the remaining half is added in the subsequent taxable year. An account balance would be reduced by the amounts realized (fair market value, in the case of certain transfers other than a sale) on disposition of assets which had been assigned to the account. The recovery deduction for an account would be computed by multiplying the account balance at the close of a taxable year times the appropriate recovery percentage. This deduction would be subtracted from the account to determine the opening balance in the account for the following year.

For each taxable year, a taxpayer would elect a separate recovery percentage, within limits, to apply to each recovery account. The permissible recovery percentages would reflect the benefits of continually using a declining balance method, not more rapid than 150 percent and not less rapid than 75 percent, and assuming a recovery period of 3 years for property in category 1 and 5 years for property in category 2. Technically, this would mean that the cost of an asset would never be completely written off. However, for a broad range of discount rates, the present value of the economic benefit of cost recovery under the bill (using the highest permissible recovery percentage in either recovery account) would be very nearly the same as cost recovery under present ACRS rules, taking into account the investment credit in each case.

Category 1

Property that is assigned to the 3-year class under present ACRS rules, excluding public utility property, would be assigned to category 1. The recovery percentage that a taxpayer could select for the corresponding open-ended recovery account could be no greater than 50 percent and no smaller than 25 percent for any taxable year. The investment credit for qualifying property in category 1 would generally continue to be 6 percent, as under present law. However, the bill would allow a taxpayer to elect to place in category 2 any item of post-1982 recovery property that would otherwise be in category 1. The investment credit for qualifying property for which this election is made would be 10 percent.

To illustrate the operation of the open-ended system for assets in category 1, assume that a calendar-year taxpayer places a single $100 asset in service in 1983, that the taxpayer elects 50 percent as the recovery percentage in every year, that the asset qualifies for the investment credit, and that the taxpayer acquires no additional assets. The amount of the credit would be $6, available in 1983. The amounts added to the corresponding recovery account under the half-year convention would be $50 in 1983 and $50 in 1984. The recovery deduction for 1983 would be $25 (50 percent times the closing balance of $50). The 1984 closing balance would be $75 (the 1984 opening balance of $25 plus $50 of acquisition cost under the half-year convention) and the cost recovery deduction for 1984 would be $37.50. If the taxpayer continues to use the asset beyond 1984, the recovery deduction for a particular year would be one-half as great as the recovery deduction in the preceding year.

Category 2

Property that is assigned to the 5-year class under present ACRS rules, excluding public utility property, would be assigned to category 2. The recovery percentages that a taxpayer could select for the corresponding open-ended recovery account could be no greater than 30 percent and no smaller than 15 percent for any taxable year. The investment credit for qualifying property in category 2 would be 10 percent. This would be the same credit as under present law, except for category-1 property which the taxpayer elects to treat as category-2 property (discussed above).

Progress expenditures

Cost recovery for qualified progress expenditures made after 1985 would start in the taxable year the expenditures are made (using the half-year convention provided by the bill), if the completed asset would be post-1982 recovery property when placed in service. The cost of the asset placed in service would be added to a recovery account only to the extent it exceeds progress expenditures for the asset which were previously taken into account.

Disposition of assets and recapture

Under the open-ended account system, gains and losses on the disposition of assets would generally be deferred. Instead of immediate gain or loss recognition, the amount realized would reduce the appropriate account balance which, in turn, would reduce the amount of recovery deductions in the year of the disposition and in subsequent years. If the amount realized reduces the account balance to a negative amount, such amount would generally be treated as a capital gain under section 1231, and section 1245 recapture would not apply. The amount so treated would be reduced to the extent of one-half of the depreciable bases of assets placed in service (or qualified progress expenditures made) during the taxable year. No reduction in the balance of a recovery account would be made by reason of a tranfer at death.

In general, the fair market value of an asset would be subtracted from the appropriate recovery account in the case of transfers other than a sale. Property which ceases to qualify for cost recovery, such as property which is converted to personal use, would be treated as disposed of at fair market value.

The bill would provide special rules for the treatment of like-kind exchanges, involuntary conversions, and certain transactions where basis carries over. In the case of like-kind exchanges or involuntary conversions where the properties were assigned to the same recovery account, no changes would be made to the account unless additional consideration in the form of money or other nonqualifying property were involved. Where such additional consideration is involved or the properties exchanged were assigned to different recovery accounts, adjustments would be made in accordance with regulations to be prescribed by the Treasury Department. In a disposition where post-1982 recovery property is tranferred and the transferee's basis is determined by reference to the adjusted basis of the transferor, the transferor's recovery account would generally be reduced by an amount which bears the same ratio to the account balance as the fair market value of the transferred property bears to the fair market value of all assets (including the transferred property) in the account. The transferee's basis in the transferred property would be the amount by which the transferor's account was reduced.

Earnings and profits

In the case of post-1982 recovery property, earnings and profits would be computed in the same way as recovery deductions, except that recovery percentages of 25 percent for the category-1 recovery account and 15 percent for the category-2 account would be used in every taxable year. Two separate accounts would be maintained for this purpose.

Effective Date

In general, the provisions of the bill would apply to property placed in service by the taxpayer after December 31, 1982, in taxable years ending after that date. The provisions relating to qualified progress expenditures would apply to expenditures made by the taxpayer after December 31, 1985, in taxable years ending after that date.