[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (H.R. 676, H.R. 2697, H.R. 4114, H.R. 4357, H.R. 5028 AND H.R. 5361)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 12, 1984

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 April 12, 1984, by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.

The bills scheduled for the hearing are H.R. 676 (relating to debt financed property of educational organizations); H.R. 2697 (and H.R. 358 and H.R. 3212) (relating to charitable expense deduction for use of passenger automobile); H.R. 4114 (relating to employee stock options); H.R. 4357 (relating to stockholder protection regarding corporate acquisitions); H.R. 5028 (permanent exclusion for benefits under qualified group legal services plans); and H.R. 5361 (five-year extension of the exclusion for benefits under qualified group legal service plans).

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. 676—Messrs. Shannon, Martin, Gephardt, Frenzel, Heftel, Vander Jagt, Fowler, Downey, Matsui, et al.

Debt-Financed Property of Educational Organizations

Under present law, generally a tax-exempt organization is subject to tax on any income from an unrelated trade or business. However, the income or gain received with respect to debt-financed real property held by a qualified pension trust is not treated as unrelated trade or business income under certain circumstances. The bill would extend the exception from the debt-financed property rules to certain educational institutions. The bill would apply for taxable years beginning after December 31, 1982.

2. H.R. 2697—Ms. Mikulski, Messrs. Campbell, Jacobs, and Guarini, and Others

Charitable Expense Deduction for Use of Passenger Automobile

In determining the amount of the charitable contribution deduction under present law, taxpayers may deduct their actual operating expenses for a vehicle used to provide services to a charitable organization, or they may use a standard rate of nine cents a mile.

Under the bill, taxpayers would be allowed to determine their charitable deduction for use of a passenger automobile pursuant to the standard mileage rate authorized for computing the business expense deduction for business use of a passenger automobile. At present, that rate generally is 20.5 cents a mile for the first 15,000 miles of business use, and 11 cents a mile for each additional mile. The bill would apply to taxable years beginning after 1983.

3. H.R. 4114—Messrs. Guarini, Campbell, Frenzel, Ford of Tennessee, Duncan, Matsui, Vander Jagt, and Thomas of California

Employee Stock Options

Under present law, an employee generally recognizes income upon the exercise of an employee stock option to the extent the value of the stock exceeds the exercise price, and the employer has a corresponding deduction. The bill would allow the employee's income and employer's deduction to be deferred until the stock is disposed of. The bill would apply to options exercised after date of enactment of the bill.

4. H.R. 4357—Mr. Stark

Shareholder Protection in Corporate Acquisitions

Under present law, gain recognized by a shareholder on the sale or exchange of corporate stock is generally treated as capital gain. Furthermore, gain realized by such a shareholder in certain sales or exchanges of corporate stock is not immediately recognized. For example, the sale or exchange may be structured as an installment sale, in which case the seller may defer recognition until payments with respect to the installment sale are received. Furthermore, the sale or exchange may be a part of a tax-free reorganization, in which case the taxpayer generally recognizes no gain but transfers its basis in the stock transferred to the stock received.

Present law also permits a corporation to deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. For this purpose, ordinary and necessary expenses include reasonable allowances for salaries or other compensation for personal services actually rendered. Compensation to an individual and similar payments are generally includible in gross income only when received.

Under the bill, special rules would apply in the case of a person owning one percent or more of the total combined voting power of all classes of stock entitled to vote of a corporation. If the consideration to be received for such stock by any such person exceeds the prevailing market price for stock of the corporation at the time of the transaction, any gain shall be treated as ordinary income. Furthermore, the entire gain shall be recognized at the time of the transaction notwithstanding any other provision of the Code.

Also under the bill, no deduction would be allowed to a corporation with respect to any amounts paid or accrued under a management protection agreement. Furthermore, the present value of all payments to be made under such an agreement would be includilbe in gross income, as ordinary income, by the employee who is to receive such payments at the time such employee's employment relationship with the corporation is terminated. In general, a management protection agreement is any agreement under which one or more payments are to be made to an employee if the employee's employment with the corporation is terminated after a change in ownership or control of the corporation.

The bill would be apply to transactions entered into after November 10, 1983.

5. H.R. 5361—Mr. Stark, and H.R. 5028—Mr. Biaggi

Exclusion for Benefits Under Group Legal Services Plans

Under present law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) are excluded from an employee's gross income for income tax purposes and from wages for employment tax purposes. Present law also provides that an organization created exclusively to form part of a qualified group legal services plan may be exempt from income tax. The exclusion for prepaid legal services and the tax exemption for group legal services organizations are scheduled to expire for taxable years beginning after December 31, 1984.

H.R. 5361 would provide a five-year extension of the exclusion from gross income for payments to or under a qualified group legal services plan and the tax-exempt status of group legal services organizations. H.R. 5028 would make these provisions permanent. The bills would be effective on the date of enactment.

II. DESCRIPTION OF THE BILLS

1. H.R. 676—Messrs. Shannon, Martin, Gephardt, Frenzel, Heftel, Vander Jagt, Fowler, Downey, Matsui, et al.

Debt-Financed Property of Educational Organizations

Present Law

Under present law, any qualified pension trust or organization that is otherwise exempt from Federal income tax generally is taxed on income from trades or businesses that are unrelated to the organization's exempt purposes (Code sec. 511). Specific exclusions are provided for certain types of income, including rents, royalties, dividends, and interest.

Present law (sec. 514(a)) provides that an exempt organization's income from "debt-financed property" generally is subject to tax as unrelated business income in the proportion in which the property is financed by debt. Debt-financed property is defined as any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)). A debt constitutes acquisition indebtedness if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred but for the acquisition or improvement of the property (sec. 514(c)).

Present law provides an exception to the rule requiring taxation of debt-financed property. Under this exception, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property is not considered "acquisition indebtedness" (sec. 514(c)(9)). Thus, income or gain received from, or with respect to, such debt-financed property is not treated as income from debt-financed property. However, this exception does not apply if any of the following conditions are not met: (1) if the acquisition price is not a fixed amount determined as of the date of acquisition; (2) if the amount of the indebtedness, or the amount payable thereon, or the time for making any payments, is dependent (in whole or in part) upon revenues derived from the property; (3) if the property is leased by the qualified pension trust to the seller or a person related to the seller; (4) if the property is acquired by the qualified trust from a person related to the plan under which the trust is formed or if such property is leased to such a related person; and (5) if the seller, a person related to the seller, or a person related to the plan provides nonrecourse financing for the transaction, and the debt is subordinate to any other indebtedness on the property or the debt bears a less than arm's-length interest rate.

Explanation of the Bill

Under the bill, the present law exception to the debt-financed property rules for real property of a qualified pension trust would be extended to certain educational institutions (and certain affiliated support organizations). Eligible educational institutions are those institutions which normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where their educational activities are regularly carried on.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1982.

Revenue Effect

The bill would reduce fiscal year budget receipts by $27 million in 1984, $50 million in 1985, $62 million in 1986, $78 million in 1987, $97 million in 1988, and $121 million in 1989.

Other Congressional Action

The Senate Finance Committee adopted, as part of its deficit reduction provisions approved on March 21, 1984, a similar provision, but required that (1) in the case of a partnership, all partners be eligible institutions and (2) no part of the property be financed by the seller.

2. H.R. 2697—Ms. Mikulski, Messrs. Campbell, Jacobs, and Guarini, and Others [1]

Charitable Expense Deduction for Use of Passenger Automobile

Present Law

Unreimbursed out-of-pocket expenses incurred by a taxpayer incident to the rendition of services provided to a charitable organization, such as fuel costs for a vehicle, are treated as charitable contributions (Treas. Reg. sec. 1.170A-1(g)). In determining the amount of the contribution deduction attributable to the operation of a vehicle, the taxpayer may deduct actual expenses, or may use a standard rate. At present, the standard rate for charitable deduction purposes is nine cents a mile (Rev. Proc. 82-61, 1982-2 C.B. 849). Under either computation method, the taxpayer may also deduct parking fees and tolls, but may not deduct general repair or maintenance costs, depreciation, insurance, or other expenses.

Explanation of the Bill

Under the bill, taxpayers would be allowed to determine the amount of their charitable contribution deduction for the use of a passenger automobile pursuant to the standard mileage rate applicable for that year in computing the business expense deduction for business use of a passenger automobile.

As most recently established, the standard mileage rate which may be used in computing the business expense deduction for business use of a passenger automobile (if the vehicle is not fully depreciated) is 20.5 cents a mile for the first 15,000 miles of business use during the taxable year, and 11 cents a mile for each additional mile (Rev. Proc. 82-61, *supra,* as modified by Rev. Proc. 83-74, 1983-41 I.R.B. 16).

Effective Date

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

Revenue Effect

The bill would reduce fiscal year budget receipts by $18 million in 1984, $120 million in 1985, $141 million in 1986, $166 million in 1987, $196 million in 1988, and $231 million in 1989.

[1] H.R. 358 (introduced by Mr. Roe) and H.R. 3212 (introduced by Mr. Hammerschmidt) are similar to H.R. 2697.

Other Congressional Action

The Senate Committee on Finance adopted, as part of its deficit reduction provisions approved on March 21, 1984, an increase to 12 cents per mile in the standard mileage rate for charitable deduction purposes, effective January 1, 1985.

3. H.R. 4114—Messrs. Guarini, Campbell, Frenzel, Ford of Tennessee, Duncan, Matsui, Vander Jagt, and Thomas of California

Employee Stock Options

Present Law

Under present law, the tax treatment of employee stock options generally is governed by section 83 and the regulations thereunder (Treas. Reg. S1.83-7). Under these rules, the value of a stock option constitutes ordinary income to the employee when granted only if the option itself has a readily ascertainable fair market value at that time. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time.[1] Instead, when the option is exercised, the difference between the value of the stock at exercise[2] and the option price constitutes ordinary income to the employee.

An employer who granted a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

In addition, present law provides for "incentive stock options", under which there are no tax consequences when the option is granted or, except for the alternative minimum tax, when the option is exercised, and the employee generally is taxed at capital gains rates when the stock received on exercise of the option is sold. No business expense deduction is allowed to the employer with respect to an incentive stock option (sec. 421(a)).

Explanation of the Bill

The bill provides that an individual may defer the amount otherwise includible in income (under section 83(a)) upon the exercise of an employee stock option until the individual disposes of the stock. The employer's deduction will be deferred until the amount is included in the employee's income. For this provision to apply, the employer and employee must make a joint election in accordance with Treasury regulations. The amount included in ordinary income upon disposition of the stock will not be affected by subsequent changes in the value of the stock. The amount so included will be added to the basis of the stock for purposes of determining gain or loss from the disposition of the stock. A disposition includes a sale, exchange, gift, transfer by reason of death[3] or other transfer of title other than certain tax-free exchanges or pledges.

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[1] Section 83 does not apply to the transfer of an option without a readily ascertainable fair market value (sec. 83(e)(3)). Treas. Reg. S1.83-7(a) implies that no income is realized upon grant of such an option.

[2] For this purpose, the value of the stock is determined without regard to restrictions other than restrictions which by their terms will never lapse.

[3] The income will be included on the decedent's last return.

In order to be eligible to elect the special treatment, the individual, at the time the option is granted, must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc.

For an option to qualify for the special treatment an option must meet the following conditions:

(1) The option is not an incentive stock option (sec. 422A) and is not an option granted pursuant to an employee stock purchase plan (sec. 423).

(2) The option by its terms requires that stock certificates issued upon exercise of the option be retained by the corporation or its agent for the benefit of the employee, or requires the use of restrictive legends or stop-transfer instruction with respect to the stock certificates. An option meets this requirement if the terms of the option require that any stock certificate of a corporation issued upon exercise of the option indicates on the face of the certificate that transfer of the stock is subject to the provision of notice to the corporation of the transfer.

(3) The corporation must notify the Internal Revenue Service of the sale of the option stock.

Effective Date

The bill would apply to options exercised after date of enactment.

Revenue Effect

The bill would reduce fiscal year budget receipts by a negligible amount in 1984 and 1985, $12 million in 1986, $18 million in 1987, $7 million in 1988, and by a negligible amount in 1989.

Other Congressional Action

The Senate Finance Committee adopted, as part of its deficit reduction provisions approved on March 21, 1984, a similar provision, but limited its application to options meeting a number of restrictive conditions, including certain nondiscrimination rules.

4. H.R. 4357—Mr. Stark

Shareholder Protection in Corporate Acquisitions

Present Law

In general

When one corporation acquires the stock or assets of another corporation, the consideration involved usually is received by the shareholders of the acquired corporation in exchange for their stock in the acquired corporation. If that consideration is cash or certain other property, the shareholders will generally recognize gain (or loss), measured by the difference between the value of the consideration received at the time they receive it and their basis in the stock exchanged. Such gain (or loss) is usually capital gain (or loss). Capital gain is taxed at a lower rate than ordinary income.

The acquisition transaction may be structured as an installment sale. In an installment sale, the acquiring corporation uses its own installment obligations as the consideration. In an installment sale, gain realized by a shareholder is generally not recognized at the time of the transaction. Rather, it is recognized only as payments under the installment obligations are made. Such payments are prorated between gain realized and the shareholder's basis in the stock exchanged. When the gain is recognized, it is generally capital in character.

The acquisition transaction may also be structured as a reorganization. In a reorganization, the acquiring company generally issues shares of its stock to shareholders of the acquired corporation. Gain realized by such shareholders is generally not taxable. Rather, they take a basis in the stock received equal to their basis in the stock of the acquired corporation surrendered. As a result, gain realized in the reorganization will be taxed only when and if the stock received is subsequently sold or exchanged in a taxable transaction.

Present law permits corporations to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses include reasonable salaries or other compensation for personal services actually rendered. They can also include severance, or termination, pay. Generally, unfunded compensation, including severance or termination pay, is includible as ordinary income by the recipient. However, it is generally not includible until it is received.

Corporate acquisition considerations

For a variety of reasons, in recent years there has been a large increase in corporate acquisition activity. Under Federal and State securities law and in accordance with sound acquisition practices, a corporation desiring to acquire another corporation will often seek the blessing of the management and, perhaps, large shareholders of the target corporation for the offer proposed to be made before it is made. Occasionally, in order to obtain that blessing, the potential acquiring corporation will make arrangements with key management and large shareholders of the target (often the same persons) pursuant to which special additional payments will be made to them. Such special payments may run afoul of applicable securities laws because they can result in unwarranted special treatment for certain persons. Furthermore, from a tax perspective, such payments, while they may be cast as payments for stock, may have a significant compensatory component.

In other situations, the potential acquired corporation may resist being taken over and seek to put into place certain defense mechanisms. One currently popular defense mechanism is the "golden parachute" contract or management protection agreement. Under a typical golden parachute contract, a corporation will contract with key individuals, agreeing to pay them large sums of money if it is successfully taken over and the employment of such individuals is terminated. One goal of such a contract is to make hostile takeover more expensive, and therefore less attractive, for a would-be acquiring corporation. If payments are made under such a contract, the corporation will attempt to deduct them. Under present law, the deductibility of such payment may, in particular cases, be unclear. In any event, many have argued that golden parachute contracts are not in the best interests of the corporation's shareholders generally and ought to be discouraged. Among other things, such contracts may serve to entrench existing management by inhibiting a takeover and to provide a windfall to certain individuals if the defense strategy is unsuccessful.

Explanation of the Bill

The bill would provide special rules in the case of one percent or larger shareholders for whom special arragements are made in the context of an acquisition. The bill would also impose special rules with respect to certain management protection agreements.

Under the bill, one percent or larger shareholders of a corporation who receive for their stock more than the prevailing market price for stock of such corporation at the time of the transaction would be required to include all their gain in income as ordinary income. Furthermore, that income would be includible at the time of the transaction. Finally, that income would be includible notwithstanding any other provisions (including the installment sale provisions and the reorganization provisions) of the Code.

For these purposes, a one percent shareholder is any person who owns (directly or after application of the attribution rules of section 318) one percent or more of the total combined voting power of all classes of stock entitled to vote of a corporation.

No deduction would be allowable to the corporation for any amount paid or incurred in connection with a transaction of the type referred to above.

The bill would also provide that no deduction is to be allowed with respect to amounts paid or accrued under management protection agreements. Furthermore, the present value of all amounts to be received under management protection agreements would be includible in gross income, as ordinary income, by the individual involved at the time his or her employment is terminated, regardless of when those amounts are to be received.

For purposes of these rules, a management protection agreement is any agreement pursuant to which payments are to be made to an employee of a corporation if such employee's employment is terminated within a specified period of time after a change in the ownership or control of the corporation. However, a management protection agreement does not include any agreement that does not discriminate in favor of employees who are officers, shareholders, or highly compensated persons.

Effective Date

The bill would be effective with respect to transactions entered into after November 10, 1983.

Revenue Effect

The bill would increase fiscal year budget receipts by less than $10 million annually.

Other Congressional Action

The Senate Finance Committee adopted, as part of its deficit reduction provisions approved on March 21, 1984, certain provisions regarding golden parachute contracts, as specifically defined.

5. H.R. 5361—Mr. Stark and H.R. 5028—Mr. Biaggi

Exclusion for Benefits Under Group Legal Services Plans

Present Law

In general

Under present law, amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) are excluded from an employee's gross income for income tax purposes (sec. 120) and from wages for social security and unemployment insurance tax purposes (secs. 3121(a)(17), 3306(b)(12)). The exclusion also applies to any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee (or the employee's spouse or dependents).

In order to be a qualified plan under which employees are entitled to tax-free benefits, a group legal services plan must fulfill several requirements with regard to its provisions, the employer, and the covered employees.

Legal services

A qualified group legal services plan must be a separate written plan of an employer for the exclusive benefit of employees or their spouses or dependents. The plan must supply the employees, their spouses, and dependents with specified benefits consisting of personal (i.e., nonbusiness) legal services through prepayment of, or provision in advance for, all or part of an employee's, or an employee's spouse, or dependent's legal fees.

Present law also provides that amounts contributed by employers under a qualified group legal services plan may be paid only (1) to insurance companies or to organizations or persons that provide personal legal services or indemnification against the cost of personal legal services, in exchange for a prepayment or a payment of a premium; (2) to organizations exempt from taxation as organizations described in section 501(c)(20) (see below for description); (3) to organizations described in section 501(c) that are permitted to receive employer contributions for one or more qualified groups legal services plans, provided the organizations pay or credit the employer contributions to another organization that is described in section 501(c)(20); (4) as prepayments to providers of legal services under the plan; or (5) to a combination of the four permissible types of payment arrangements.

Group legal services organization

Present law also provides that an organization or trust created or organized in the United States whose exclusive function is to form part of a qualified group legal services plan under section 120 is exempt from income tax (sec. 501(c)(20)). Such a trust is subject to the rules generally governing organizations described in section 501(c), including the taxation of any unrelated business income. An exempt organization or trust which receives employer contributions for a group legal services plan because of section 120(c)(5)(C) is not prevented from qualifying for exemption under section 501(c)(20) merely because it provides legal services or indemnification for legal services unassociated with a qualified group legal services plan.

Nondiscrimination

In order to be a qualified plan, a group legal services plan must also meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment.

Present law requires that the contributions paid by an employer and the benefits provided under a plan may not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated. The plan must benefit employees who qualify under a classification which the employer sets up and which the Internal Revenue Service determines does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated. However, in determining whether a classification is discriminatory, the employer may exclude from the calculations those employees who are members of a collective bargaining unit if there is evidence that group legal services plan benefits were the subject of good faith bargaining between representatives of that group and the employer.

A limit is placed on the proportion of the amounts contributed under the plan that can be applied for employees who own more than five percent of the stock or of the capital or profits interest in the employer corporation or unincorporated trade or business. The aggregate of the contributions for those employees or their spouses and dependents must not be more than 25 percent of the total contributions.

Other rules

Under present law, in order to be treated as a qualified group level services plan, the plan must notify the Internal Revenue Service that it is applying for recognition of this qualified status. If the plan fails to notify the IRS by the time prescribed in Treasury regulations, then the plan cannot be regarded as a qualified plan for any period before it in fact gave notice.

An individual who qualifies as an employee within the definition of Code section 401(c)(1) is also an employee for purposes of these group legal services provisions. This means that, in general, the term employee includes self-employed individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year. An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

Requirement for report from executive agencies

The Tax Reform Act of 1976 (sec. 2134(d)) required the Secretary of the Treasury and Secretary of Labor to submit to the President and the Congress a report on the desirability and feasibility of continuing the exclusion from income of prepaid group legal services benefits. The report was required to be submitted by December 31, 1980.

The report described above has not yet been submitted to the Congress.

Termination

The present-law exclusion for prepaid legal services and the tax exemption for group legal services organizations are scheduled to expire for taxable years beginning after December 31, 1984.

Explanation of the Bills

H.R. 5361

The bill would extend, to be applicable to taxable years beginning before January 1, 1990, the exclusion from gross income and wages for payments to or under a qualified group legal services plan and the tax-exempt status of group legal services organizations.

H.R. 5028

The bill would make permanent the exclusion from gross income and wages for payments to or under a qualified group legal services plan and the tax-exempt status of group legal services organizations.

Effective Date

The bills would be effective on the date of enactment.

Revenue Effect

Either bill would reduce fiscal year budget receipts by $32 million in 1985, $48 million in 1986, $52 million in 1987, $56 million in 1988, and $60 million in 1989.

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