[JOINT COMMITTEE PRINT]

DESCRIPTION OF MISCELLANEOUS TAX BILLS

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON APRIL 25, 1980

PREPARED FOR THE USE OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on April 25, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. There are 10 Senate bills and one section of a House-passed bill described in the pamphlet.

The first part of the pamphlet is a summary of the bills generally presented in bill numerical order for Senate bills and then for the section of the House-passed bill. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

I. SUMMARY

1. S. 753—Senator Inouye

Increase in Tax Credit for the Elderly

Under present law, individuals who are age 65 or older are entitled to a tax credit equal to 15 percent of their credit base minus certain offsets. Currently, the credit base is:

$2,500 -----	Single individual or joint return where only one spouse is ineligible;
$3,750 -----	Joint return where both the spouses are eligible; or
$1,875 -----	Married individuals filing a separate return.

This credit base generally is reduced for amounts received as tax-free pensions or annuities. In addition, it also is reduced by one-half of adjusted gross income in excess of the following limitations:

$7,500 -----	Single individuals;
$10,000 -----	Joint returns; or
$5,000 -----	Married individuals filing separate returns.

The bill would increase the credit base to $3,000 for a single person, $4,500 for a married couple where both spouses are age 65 or over, and $2,250 for married individuals filing a separate return. Moreover, the bill would increase the adjusted gross income limitation to $15,000 for a single person, $17,500 for a married couple where both spouses are 65 or older, and $8,750 for a married individual filing separately.

2. S. 1384—Senators Hatfield, Stewart, Armstrong, Melcher, Nunn, Stevens, and McGovern

Tax Credit for Contributions of Crops to Certain Tax-Exempt Organizations

In general, the bill would provide a nonrefundable income tax credit for a taxpayer engaged in the farming business with respect to crops contributed to a charity which uses the crop in a use related to its exempt function. The credit would be 10 percent of the amount of a qualified crop contribution.

3. S. 1826—Senator Durenberger

Casualty Loss Deduction for Tree Losses Caused by Dutch Elm Disease

Under present law, the loss of an elm tree as a result of infection of Dutch elm disease has been held not to constitute a casualty loss deductible for income tax purposes.

The bill would provide that a property loss resulting from Dutch elm disease is treated as a deductible casualty loss.

4. S. 1854—Senator Johnston

Election To Treat Income From Spacecraft as From U.S. Sources

The bill would permit lessors of communications satellites manufactured in the United States to elect to treat their income or loss from the lease as from United States, rather than foreign, sources. This would prevent possible loss of foreign tax credits to the lessors during the early years of the lease, when depreciation and other deductions generally exceed gross income.

5. S. 1867—Senator Durenberger

Charitable Deduction for Automobile Expenses

The bill would allow taxpayers to determine the amount of their charitable contribution deductions for motor vehicle expenses on the basis of the reimbursement rate allowed Government employees for the use of their own motor vehicles in official Government business.

6. S. 2179—Senators Hayakawa and Cranston

Definition of Artificial Bait for Purposes of the Excise Tax on Fishing Equipment

Present law imposes a 10-percent excise tax upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies by the manufacturer, producer, or importer thereof.

The bill would exclude from the category "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.

7. S. 2239—Senators Packwood, Nelson, and Cranston

Incentive Stock Options

Generally, under present law, an employee is taxed on a compensatory stock option at the time the option is received, or, if the option does not have a readily ascertainable fair market value, at the time it is exercised. The employer has a corresponding deduction as a business expense.

Under the bill, a stock option meeting certain requirements which is granted to an employee would be taxed at capital gains rates when the employee sells the stock. The employer would receive no deduction.

The bill would apply to options granted after the date of enactment.

8. S. 2367—Senator Boren

Gain on Sale of Stock of Foreign Investment Company

Under present law, gain from the sale of stock of a corporation which at any time is a foreign investment company generally is treated as ordinary income to the extent of the selling shareholder's portion of the corporation's earnings and profits. Under the bill, gain attributable to earnings and profits for the period before the corporation became a foreign investment company would not be subject to this ordinary income treatment.

9. S. 2396—Senator Jepsen

Treatment of Certain Finance Companies as Personal Holding Companies

Under present law, a tax is imposed on the undistributed personal holding company income of a personal holding company. Generally, personal holding company income includes interest. A corporation actively engaged in a lending or finance business is exempted from this tax if the corporation has qualifying business expenses equal to 15 percent of its ordinary gross income from its lending or finance business up to $500,000, plus five percent of such ordinary gross income from $500,000 to $1 million. The term "lending or finance business" is defined to include the business of making loans with maturities of no more than 60 months.

The bill would increase the 60-month limitation of present law to 144 months, and would amend the definition of a lending or finance business to include the business of making certain types of revolving credit loans. The bill would also amend the business expense test of present law to require a lending or finance business to have qualifying business expenses equal to 15 percent of its ordinary gross income from the lending or finance business up to $500,000 plus five percent of such ordinary gross income in excess of $500,000. In other words, the $1 million ordinary gross income amount would be eliminated for purposes of applying the qualifying business expense test.

10. S. 2415—Senator Packwood

Qualification of Leased Furniture for the Investment Tax Credit

Under present law, property used predominately to furnish certain lodging does not qualify for the investment tax credit. Generally, this rule applies to property used for nontransient residential purposes since qualified investment for property used by a hotel or motel is eligible for the investment tax credit. Under the bill, furniture acquired by a person who is engaged in the trade or business of renting or leasing furniture to others would qualify for the investment tax credit, irrespective of the use made of such property by the lessee. Thus, furniture leased to an apartment owner or a tenant would be eligible for the credit.

11. Section 4 of H.R. 5973

Special Rule Relating to Debt-Financed Income of Exempt Organizations

Generally, under present law, passive investment income and gains from the sale of investments realized by an exempt organization are not subject to tax as unrelated business income. However, income and gains realized by an exempt organization from "debt-financed property" not used for its exempt function are subject to tax in the proportion in which the property is financed by acquisition indebtedness.

This section would provide a limited exception to the debt-financed income rules. This exception would allow certain sales of real property in 1976 to be made free of the unrelated business income tax if the property had been acquired prior to 1952 and the indebtedness was incurred before 1965. The intended beneficiary of the provision is the Tillamook County YMCA of Tillamook, Oregon.

II. DESCRIPTION OF BILLS

1. S. 753—Senator Inouye

Increase in Tax Credit for the Elderly

Present law

Under present law, an individual taxpayer who is age 65 or older is entitled to a tax credit equal to 15 percent of his or her credit base minus certain offsets (Code sec. 37). Currently, the credit base is:

$2,500------	Single individual or joint return where only one spouse is eligible;
$3,750------	Joint return where both the spouses are eligible; or
$1,875------	Married individuals filing a separate return.

This credit base is reduced by certain amounts received as a tax-free pension or annuity (for example, under Social Security or the Railroad Retirement Act). The credit base also is reduced by one-half of adjusted gross income in excess of certain limitations. These limitations are:

$ 7,500-----	Single individuals;
$10,000-----	Joint returns; or
$ 5,000-----	Married individuals filing separate returns.

In addition, present law allows individuals under the age of 65, who have income from pensions and annuities under a public retirement system, to claim a credit equal to 15 percent of their credit base. The credit base for individuals under the age of 65 generally is the same as that for individuals who are 65 or older, and is reduced by amounts received as tax-free pensions or annuities. However, individuals under the age of 65 are not subject to an adjusted gross income limitation, but they are subject to an earned income limitation. (In general, for individuals under the age of 62, the credit base is reduced dollar-for-dollar for all earned income in excess of $900; for individuals who are age 62 or older but under 72, the credit base is reduced by 50 percent of earned income between $1,200 and $1,700 and is reduced dollar-for-dollar for earned income in excess of $1,700; for individuals who are age 72 or older, the earned income limitation does not apply.)

Issues

The bill presents two issues:

(1) Whether the credit base should be increased; and

(2) Whether the adjusted gross income limitation should be increased.

Explanation of the bill

The bill would increase the credit base as follows:

$3,000------	Single individual or joint return where only one spouse is eligible;
$4,500------	Joint return where both the spouses are eligible; or
$2,250------	Married individuals filing a separate return.

In addition, the bill would increase the adjusted gross income limitation as follows:

$15,000 ----	Single individuals;
$17,500 ----	Joint returns; or
$8,750 -----	Married individuals filing separate returns.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1978.

Revenue effect

The bill would reduce budget receipts by $278 million per year for fiscal years 1980–1984. (Of this reduction, $100 million is attributable to the higher credit base and $178 million to the higher income limitation.)

Prior Congressional action

An identical provision was contained in the Senate version of H.R. 13511 (The Revenue Act of 1978). However, the provision was deleted in Conference. In addition, a bill (H.R. 9893) containing an identical provision was reported by the Ways and Means Committee on September 25, 1978, and passed the House on October 12, 1978.

2. S. 1384—Senators Hatfield, Stewart, Armstrong, Melcher, Nunn, Stevens, and McGovern

Tax Credit for Contribution of Crops to Certain Tax-exempt Organizations

Present law

Tax credit

Under present law, no income tax credit is allowed a taxpayer for the contribution of crops or other property to tax-exempt (charitable, etc.) organizations.

Deduction for charitable contributions

Present law does provide that, with certain limitations, a taxpayer is entitled to a deduction for certain charitable contributions (Code sec. 170). In general, the amount of the deduction is equal to the fair market value of the property contributed. However, a taxpayer who makes a charitable contribution of property is ordinarily required to reduce the amount of the deduction (from fair market value) by the amount of ordinary gain he would have realized had the property been sold instead of donated to charity (Code Sec. 170(e)). (Under certain circumstances, a taxpayer is also required to reduce the amount of his charitable contribution by a portion of the capital gain he would have received if the property had been sold.) Thus, the donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) ordinarily can deduct only the basis in the property rather than its full fair market value.

When this rule was added to the Code in 1969, it was intended, in part, to address an anomaly under the tax law under which taxpayers in high marginal tax brackets and corporations could donate to charity substantially appreciated ordinary income property and actually be better off after tax than they would have been if they had sold the properties and retained all the after-tax proceeds of the sales.

The Tax Reform Act of 1976 allows a corporation (other than a subchapter S corporation) a deduction for up to half of the appreciation on certain types of ordinary income property contributed to a public charity (other than a governmental unit) or a private operating foundation.

In order to qualify for this treatment, the following conditions must be satisfied: (1) the donee must use the property in a use related to its exempt purpose and solely for the care of the ill, the needy, or infants; (2) the donee must not transfer the property in exchange for money, other property, or services; (3) the donor must receive a statement from the donee representing that its use and disposition of the property will comply with requirements (1) and (2) above; and (4) the property must satisfy the relevant requirements of the Federal Food, Drug, and Cosmetic Act in effect on the date of transfer and for 180 days prior to such transfer.

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If all these conditions are complied with, the charitable deduction is generally for the sum of (1) the taxpayer's basis in the property and (2) one-half of the unrealized appreciation. However, in no event is a deduction allowed for an amount which exceeds twice the basis of the property. Furthermore, no deduction is to be allowed for any part of the unrealized appreciation which would have been ordinary income (if the property had been sold) because of the application of the recapture provisions relating to depreciation, certain mining exploration expenditures, certain excess farm losses, certain soil and water conservation expenditures, and certain land-clearing expenditures.

The 1976 Act changes were made because Congress believed that it was desirable to provide a greater tax incentive than in prior law for contributions of certain types of ordinary income property which the donee charity uses in the performance of its exempt purposes. However, Congress believed that the deduction allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Basis of crops

Under present law, most farmers are entitled to use (and use) the cash method of accounting. As a consequence, farmers using the cash method may deduct all or most of the costs of raising crops when the costs are paid, rather than accumulating these production costs in inventory until the product is sold.[1] For most farmers, the basis of a crop is likely to be zero (or insignificant when compared with its value). Also, most farming operations are not conducted by corporations. (Consequently, the provisions allowing a charitable contributions deduction in an amount no more than double the basis of ordinary income property for corporations is not likely to provide a benefit to farmers who contribute crops to charities.)

Issues

The principal issue is whether a tax credit based on the value of a crop should be provided for farmers who contribute crops to certain charitable organizations.

Among the subsidiary issues raised by the bill are whether the bill's measurement of value of the crops contributed is appropriate and whether it is appropriate to disregard completely the marketability, grade, and quality of the crop contributed.

Explanation of the bill

The bill would provide for a nonrefundable income tax credit of 10 percent of the amount of the qualified crop contribution of the taxpayer for the taxable year. No carryover of any unused credit would be provided.

This credit would be available only to a taxpayer engaged in the trade or business of farming and only for the contribution of a crop

[1] Treas. Reg. §§ 1.162–12 and 1.471–6. However, a very limited number of farming corporations and partnerships are required to use the accrual method of accounting and to capitalize (or inventory) the costs of growing crops (Code sec. 447).

grown in connection with such trade or business. Furthermore, to qualify for the credit, the following conditions must be satisfied: (1) the contribution must be made to a tax-exempt, charitable organization (described in Code sec. 501(c)(3)); (2) the crop must be harvested by, or on behalf of, the donee; (3) the crop must be fit for human or animal consumption; (4) the donee must use the crop in a use related to its tax-exempt purpose or function; (5) the donee must not transfer the crop in exchange for money, other property (other than other crops, the use of which by the donee is related to its tax-exempt purposes), or services; and (6) the donor must receive a statement from the donee representing that its use and disposition will comply with the requirements of (4) and (5).

In determining the amount of the qualified crop contribution, the taxpayer may elect to value the crop at either the wholesale market price or the most recent sales price.[2] The wholesale market price of a crop means the lowest wholesale market price during the month in which the contribution is made. However, the determination of this price is to be made without consideration of the grade or quality of the crop and as if the crop contributed were marketable.[3] The "most recent sale price" means an amount equal to the price the taxpayer would have received for the contributed crop if he had sold the crop on the date of the most recent sale by the taxpayer of such a crop and the same market price per unit as the crop sold on such date.[4]

The bill would provide that no credit is to be allowed "with respect to any amount for which a deduction is allowed" for the taxable year. It appears that the intent of this provision is to preclude only the claiming of a credit with respect to any portion of a crop for which a charitable contributions deduction is claimed. It is arguable that the provision could be interpreted as denying the credit in any case in which the taxpayer has deducted amounts attributable to feed, seed, fertilizer, or other farm expenses attributable to the contributed crop.

Effective date

The bill would apply to qualified crop contributions made in taxable years beginning after December 31, 1979, but it would not apply to any qualified crop contribution made after December 31, 1982.

Revenue effect

It is estimated that this bill would reduce budget receipts by a negligible amount in fiscal year 1980 and by less than $5 million per year for fiscal years 1981–1983.

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[2] It is not clear whether the election is to be made on a contribution-by-contribution basis, or for all contributions made during the year. Also, it is not clear whether, or under what circumstances, the election may be revoked or amended.

[3] It is not clear how the wholesale market price is determined if there are a number of grades or qualities of the crop which are marketed on such an exchange.

[4] It is not clear what would happen if various grades or qualities of the crop were sold on the same date. However, it does appear that, in determining the most recent sale price, the grade or quality (and perhaps marketability) could be taken into account.

3. S. 1826—Senator Durenberger

Casualty Loss Deduction for Tree Losses Caused by Dutch Elm Disease

Present law

Under present law, an individual may deduct the amount of a property loss sustained during the taxable year in a trade or business, or in a transaction entered into for profit, to the extent the loss is not insured or otherwise recoverable. If a property loss is not incurred in a trade or business or in a for-profit transaction, the amount of unrecoverable loss is deductible (subject to a $100 floor per occurrence) by an individual who itemizes deductions on his or her Federal income tax return only if the loss arises from theft or "from fire, storm, shipwreck, or other casualty . . ." (Code sec. 165(c)(3)).

The statute does not further define the meaning of the term "other casualty" for purposes of the section 165(c)(3) casualty loss deduction. The courts, applying the interpretative rule of *ejusdem generis*, generally have held that the term "other casualty" refers only to sudden, unexpected events, as characteristic of fires, storms, or shipwrecks.[1] The requirements of suddenness and unforseeability of the occurrence preclude deductions for damage done to property over a period of time, such as progressive deterioration caused by continuing action of insects or the weather. For example, the casualty deduction generally is not allowed for losses caused by termites, moths, carpet beetles, infestation of rats, livestock disease, dry rot, prolonged drought, leakage, erosion, dampness, or gradual suffocation of tree roots.[2]

Applying the suddeness standard, the Sixth Circuit has ruled [3] that

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[1] See, e.g., *Appleman* v. *U.S.*, 338 F.2d 729 (7th Cir. 1964), *cert. denied*, 380 U.S. 956 (1965); *Matheson* v. *Comm'r*, 54 F.2d 537 (2d Cir. 1931); *W. W. Bercaw*, 6 CCH Tax Ct. Mem. 27 (1947), *aff'd*, 165 F.2d 521 (4th Cir. 1948); Rev. Rul. 72–592, 1972–2 C.B. 101; Rev. Rul. 61–216, 1961–2 C.B. 134.

[2] See, e.g., *U.S.* v. *Rogers, Exec.*, 120 F.2d 244 (9th Cir. 1941) (termites); Rev. Rul. 63–232, 1963–2 C.B. 97 (termites); Rev. Rul. 55–327, 1955–1 C.B. 25 (moths); *Meersman* v. *U.S.*, 370 F.2d 109 (6th Cir. 1966) (carpet beetles); *Edward W. Banigan*, 10 CCH Tax Ct. Mem. 561 (1951) (rats); Rev. Rul. 61–216, 1961–2 C.B. 134 (livestock disease); *Hoppe* v. *Comm'r*, 354 F.2d 988 (9th Cir. 1965) (dry rot); *Louis Broido*, 36 T.C. 786 (1961) (drought); *Charlie L. Wilson*, 22 CCH Tax Ct. Mem. 914 (1963) (leakage), *aff'd*, 340 F.2d 609 (5th Cir.), *cert. denied*, 382 U.S. 108 (1965); *Texas & Pacific Ry. Co.*, 1 CCH Tax Ct. Mem. 863 (1943) (erosion); *Lattimore* v. *U.S.*, 1967–2 U.S.T.C. Para. 9615 (N.D. Calif. 1967) (dampness); *William R. Miller*, 29 CCH Tax Ct. Mem. 741 (1970) (tree roots).

[3] *Burns* v. *U.S.*, 284 F.2d 436 (6th Cir. 1960), *aff'g*, 174 F. Supp. 203 (N.D. Ohio 1959).

loss of an elm tree as a result of infection of Dutch elm disease [4] does not qualify for the section 165(c)(3) casualty loss deduction. Similarly, the Seventh Circuit has held [5] that the death of elm trees as a result of phloem necrosis [6] did not constitute a "casualty" within the meaning of Code section 165(c)(3). The Court stated that, whether or not death within a month from phloem necrosis disease would be considered a "sudden" loss, the loss could not be viewed as "unexpected" because it had been common knowledge for a number of years that the disease was attacking elm trees in the area.

The Internal Revenue Service also has addressed the question whether loss of a tree caused by the disease phloem necrosis can give rise to a section 165(c)(3) casualty loss deduction. Under the facts of Rev. Rul. 57–599, 1957–2 C.B. 142, five elm trees had leafed out in early spring in apparent good health and so continued until summer, when the bark began to split open and the trees died within a few days thereafter. The cause of death was attributed to the disease phloem necrosis. In addition, four other trees in healthy condition were attacked by insects and died within ten days.

The Service ruled that loss arising from the death of a tree as a result of disease or attack by insects does not give rise to a section 165(c)(3) casualty loss deduction, since the suddenness standard is not met. The ruling states that "the very nature of the disease phloem necrosis indicates that the loss arises through a progressive deterioration rather than a sudden occurrence." Also, the ruling states that the suddenness standard is not met where a tree is killed by insect infestation, since the death of the tree is the result of progressive deterioration even though the arrival of the insects may be sudden.

Rev. Rul. 57–599 was modified by Rev. Rul. 79–174, 1979–1 C.B. 99, with respect to trees destroyed by a mass Southern pine beetle attack in an area not known for such massive attacks. In that situation, the taxpayer owned a residential lot on which 40 ornamental pine trees were growing in healthy condition. Within ten days after a mass

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[4] Dutch elm disease is a disease of elms caused by the ascomycetous fungus (*Ceratostomella ulmi*) and characterized by yellowing of the foliage, defoliation, and death (Webster's New Collegiate Dictionary (1973), at p. 355). The trial court's opinion in *Burns* v. *U.S.*, *supra* note 3, provides the following description of Dutch elm disease:

> "The Dutch Elm Disease is a fungus symptomized by the wilting of the tree leaves. The fungus is spread by the scolytus beetle, by root grafting, or by pruning tools. * * * The beetle itself, which travels from one elm tree to another, causes little or no damage. It is only when the beetle is infected with the fungus that any damage occurs.
>
> "If the bettle is infected when it bores into the tree, the fungus on its body is communicated to the food and water-conducting cells of the tree immediately beneath the bark, known as the merismatic tissue. These become afflicted with the disease and clog up and the tree becomes, in effect, starved for want of nourishment." (174 F. Supp. at 204).

[5] *Appleman* v. *U.S.*, *supra* note 1.

[6] The opinion of the Seventh Circuit in *Appleman* states: " 'Phloem' is a complex tissue in the vascular system of higher plants consisting mainly of sieve tubes and companion cells and usually also of fibre and parenchyma cells. It is part of the conductive tissue conveying the materials nourishing the plant. 'Necrosis' is the death of living tissue; the death of a plant tissue caused by fungi or other factors." (338 F.2d at 730, n. 2).

attack of Southern pine beetles,[7] all the trees were dead. Beetle attacks in epidemic proportions were unknown in the vicinity of the taxpayer's residential lot prior to that attack.

Under the facts of Rev. Rul. 79–174, the Service held that the casualty met the suddenness test inasmuch as the cambium layers of the ornamental trees were completely girdled within five to ten days after the arrival of the female beetle and since once the girdling occurred the trees were dead. Accordingly, the Service modified its earlier ruling "to remove any implication that fatal damage to ornamental trees by insect infestation can never be of a sufficiently sudden nature to meet the required elements of a casualty loss under section 165(c)(3) of the Code." However, the Southern beetle ruling did not modify Rev. Rul. 57–599 as applicable to tree death due to phloem necrosis.

Amount of loss

In the case of a partial loss of property caused by casualty within the meaning of Code section 165(c)(3), the amount of the loss equals the difference between the value of the property immediately preceding the casualty and its value immediately thereafter (Treas. Reg. § 1.165–7(b)). However, the deduction cannot exceed the property's adjusted basis (Code sec. 165(b)).

The Internal Revenue Service has ruled that "in determining the amount of a casualty loss to nonbusiness residential property, shade and ornamental trees are considered an integral part of the real property having no separate value" (Rev. Rul. 68–29. 1968–1 C.B. 74). Thus, any loss for damage to the trees resulting from a casualty must, to be allowable, be the result of an actual decrease in the value of the property as a whole. The courts have stated that the amount of loss consists of any permanent decrease in the value of the property as a whole plus any amount spent to clean up the property as the result of the casualty, e.g., cleaning up debris after a tree is hit by lightning.[8]

Consistently with the approach as to valuation in Rev. Rul. 68–29, *supra*, the courts have held that where a casualty loss is sustained to trees on residential property, no separate basis is to be assigned to the trees because they are treated as an integral part of the entire property.[9] Accordingly, the basis limitation on the casualty loss deduction affects the amount of the deduction only if the taxpayer's basis for the entire residential property (e.g., the taxpayer's house, surrounding land, and trees on the land) is less than the decrease in value to the property as a whole caused by the casualty.

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[7] The Southern pine beetle is a flying insect that normally attacks living pine trees. The female beetle bores into a tree and enters the cambium tissue beneath the bark. It then emits an attractant that leads other beetles to the tree in a mass attack. The beetles construct tunnels in the cambium tissue and deposit their eggs. These tunnels intersect and in a short time completely girdle the tree. This cuts off the food supply to the higher parts of the tree and kills it.

[8] *Ralph Walton*, 20 CCH Tax Ct. Mem. 653 (1961).

[9] See, e.g., *Western Products Co.*, 28 T. C. 1196, 1219 (1957), acq., 1958–1 C.B. 6; *Allan Hull*, 32 CCH Tax Ct. Mem. 977 (1973); *Buttram* v. *Jones*, 87 F.Supp. 322 (D. Okla. 1943).

Issue

The issue is whether a property loss resulting from Dutch elm disease should be treated as a deductible casualty loss within the meaning of Code section 165(c)(3).

Explanation of the bill

The bill would provide that a property loss resulting from Dutch elm disease is to be treated as a deductible casualty loss within the meaning of Code section 165(c)(3).

Effective date

The bill would apply to losses from Dutch elm disease incurred in taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this bill would reduce budget receipts by $30 million in fiscal year 1981 (including prior years' liability), $17 million in 1982, $19 million in 1983, $20 million in 1984, and $21 million in fiscal year 1985.

4. S. 1854—Senator Johnston

Election to Treat Income From Spacecraft as From U.S. Sources

Present law

The source of income or loss from the rental of personal property generally depends on whether the property is used inside or outside the United States. Under this rule, income from the lease of a satellite would be treated as income from sources without the United States.

Typically, under a lease financing of equipment (i.e., the equipment is purchased by a financial institution and leased to the user), the lease produces a tax loss during its early years to the lessor (primarily as a result of accelerated depreciation or amortization deductions). Where the equipment is used outside the United States, the loss arising on the lease is considered to be a foreign source loss under the generally applicable source rules. The characterization of the loss as foreign source operates to reduce the lessor's foreign source taxable income and thus its foreign tax credit limitation. Under certain circumstances, this may cause the lessor to lose a foreign tax credit, to which it would otherwise be entitled, for foreign taxes paid with respect to its other foreign operations. As a result, this type of lease-financing transaction could be less attractive than a lease-financing transaction involving equipment to be used exclusively in the United States.

A similar situation arose in the case of ships and aircraft which often are financed through long-term leases from financial institutions. Lessors expressed concern about the loss of foreign tax credits, and under the Revenue Act of 1971, lessors of certain ships and aircraft were given an election to treat all income and loss from the rental of the ships or aircraft as from sources within the United States (Code sec. 861(e)). Under this provision, if a taxpayer owns an aircraft or vessel which is eligible for the investment tax credit (or would be if not used by a government) and leases the aircraft or vessel to a United States person, other than a member of the same controlled group of corporations as the taxpayer, and if the aircraft or vessel is manufactured or constructed in the United States, then the taxpayer may elect, for any taxable year ending after the commencement of the lease, to treat all amounts includible in gross income with respect to the aircraft or vessel (whether during or after the period of any such lease), including gain from sale, exchange, or other disposition of the aircraft or vessel, as income from sources within the United States. As a corollary to this rule, losses from the lease would also be treated as from U.S. sources. The election may not be revoked without the consent of the Treasury. Moreover, if the ship or aircraft is transferred in certain transactions where gain is not fully recognized, the transferee is also bound by the election.

A similar problem also arose with respect to lease-financed U.S. railroad rolling stock used temporarily in Canada or Mexico. Under the

Revenue Act of 1978, lessors generally are required, on a non-elective basis, to treat all income or loss from the rolling stock as from U.S. sources if it is expected that the leased rolling stock will be used predominantly within the United States.

Property which is used predominantly outside the United States, or which is used by a government or international organization, is generally not eligible for the investment tax credit. Exceptions are made to the requirement for use in the United States for U.S. documented ships or aircraft, rolling stock of domestic railroads, and certain other property. Under the Revenue Act of 1971, this requirement is also waived for any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962) or interest in such a satellite of a U.S. person. In addition, the 1971 Act waives the governmental use restriction for property used by the International Telecommunications Satellite Consortium (INTELSAT).

Issue

The issue is whether, and under what circumstances, income from the lease of satellites should be treated as from U.S. sources.

Explanation of the bill

The bill would permit an election to be made to treat income or losses from a lease of a spacecraft as from U.S. sources on the same basis as the election is now afforded for lease income from a ship or aircraft. Thus, the bill would apply to communications satellites because they are property eligible for the investment tax credit. However, as in the case of the present election for ships and aircraft, the satellites would have to be manufactured in the United States.[1]

Effective date

The bill would apply to spacecraft first leased by a taxpayer after December 31, 1978.

Revenue effect

This bill is estimated to have a negligible effect on budget receipts annually.

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[1] Section 7 of H.R. 4746 would make the investment tax credit available for interests of U.S. persons in communications satellites used by the International Maritime Satellite Organization, an international organization established to develop and operate a global maritime satellite telecommunications system. H.R. 4746 was passed by the House of Representatives on September 17, 1979, and was referred to the Finance Committee.

5. S. 1867—Senator Durenberger

Charitable Deduction for Automobile Expenses

Present law

Charitable deduction

Taxpayers may claim a deduction for unreimbursed expenses for the use of the taxpayer's automobile which qualify as a charitable contribution. This deduction may be based on a standard mileage rate set periodically by the Internal Revenue Service. This rate is set to cover the out-of-pocket costs of gasoline and oil necessarily incurred in performing the donated services.[1] The present rate is eight cents per mile (IR–2165, September 27, 1979.) However, a taxpayer is not required to use the standard mileage rate. If a taxpayer's allowable nonreimbursed transportation expenses for charitable purposes exceed this rate, the taxpayer may deduct his or her actual expenses.

Taxpayers using the standard mileage rate also may deduct parking fees and tolls.

Medical and moving expense deduction

A standard mileage rate is also allowed with respect to the use of an automobile for medical and moving expense purposes (see Code §§ 213 and 217). Presently, the mileage rate is 8 cents per mile.

Trade or business expense deduction

Under Code section 162(a), self-employed individuals and employees (including Government employees) are allowed a deduction for unreimbursed expenses for the operation of their automobiles in connection with a trade or business. This deduction may be based on the standard mileage rate set periodically by the Internal Revenue Service. For taxable years beginning after December 31, 1978, the rate is 18.5 cents per mile for the first 15 thousand miles, and 10 cents per mile for the excess over 15 thousand miles. This rate is set to cover expenses for gasoline, oil, repairing, insurance, depreciation, and other operating, and fixed expenses. In addition, parking fees and tolls may be deducted as separate items (IR–2165, September 27, 1979).

Federal transportation reimbursement provisions

Reimbursements for transportation expenses for official Government business are set by the Administrator of General Services. At least once each year, the Administrator determines the average, actual cost per mile for the use of a privately owned motorcycle, automobile, and airplane during the period. In making this determination, the Administrator must review and analyze, among other factors: depreciation of original vehicle cost; gasoline and oil (excluding taxes); maintenance, accessories, parts, and tires; insurance; and State and

[1] Treas. Reg. § 1.170A–1(g). *Cf.*, Code sec. 170(h)(6), denying out-of-pocket expenditures in certain cases.

Federal taxes. (5 U.S.C. 5707.) If reimbursements are made on the basis of mileage instead of actual expenses, they may not exceed (1) 11 cents per mile for the use of a privately owned motorcycle; (2) 20 cents a mile for the use of a privately owned automobile; or (3) 24 cents a mile for the use of a privately owned airplane. If use of a privately owned vehicle in lieu of a Government vehicle is chosen by the employee, reimbursement on a mileage basis is limited to the cost of travel by a Government vehicle.

At present, the standard reimbursement rate for the use of a privately owned automobile in official Government business is 18.5 cents per mile. On March 24, 1980, the Administrator of General Services notified the Congress that the reimbursement rate is to be increased to the statutory maximum of 20 cents per mile by April 24, 1980.

In addition to the mileage allowance, the Government employee may be reimbursed for bridge, road and tunnel tolls, parking fees, ferry fees, and airplane landing and tie-down fees.

Issue

The issue is whether the deduction for motor vehicle expenses incurred for charitable purposes should be increased.

Explanation of the bill

The bill would permit taxpayers whose expenses for operating a motor vehicle qualify as a charitable contribution to claim a deduction equal to the amount of reimbursement which would be allowable if the expenses were for official business for the Government.

Effective date

The bill would apply to expenses for operating a motor vehicle after the date of enactment in taxable years ending after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $1 million in fiscal 1980, by $100 million in fiscal 1981, by $102 million in fiscal 1982, by $119 million in fiscal 1983, and by $141 million in fiscal 1984.

6. S. 2179—Senators Hayakawa and Cranston

Definition of Artificial Bait for Purposes of the Excise Tax on Fishing Equipment

Present law

Under present law, there is imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax equivalent to 10 percent of the price for which so sold (Code sec. 4161(a)).

Present law contains no statutory definition of "artificial bait" to which the tax applies. However, Treasury Regulations (Treas. Regs. sec. 48.4161(a)-2(d)) define the term "artificial lures, baits, and flies" to include all artifacts, of whatever materials made, that simulate an article considered edible to fish, and that are designed to be attached to a line or hook to attract fish so that they may be captured. Thus, the term includes such artifacts as imitation flies, blades, spoons, spinners, etc., and edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels, or tadpoles.

The Internal Revenue Service has taken the position that bait which contains very little artificial substance may be subject to the excise tax. In Revenue Ruling 71-321, 1971-2 C.B. 369, the Service holds that edible food items which are shaped or treated to give the appearance or odor of insects, flies, worms, frogs, etc., are artificial lures or baits. In addition, in Revenue Ruling 77-302, 1977-2 C.B. 374, the Service held that a floating fish bait that is manufactured from a semi-soft cheese food to which ingredients are added to provide the desired consistency, color, scent, and buoyancy, then packaged by weight and sold in a solid form that the user may shape or form, as with a fish hook, is an artificial bait or lure subject to the manufacturer's excise tax.

Issue

The issue is whether certain substances should be excluded from the term "artificial bait," for purposes of the excise tax.

Explanation of the bill

The bill would exclude from the term "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish. Thus, those types of substances would be exempt from the excise tax.

Although this provision may benefit other taxpayers, it is intended primarily to benefit the Don Rich Company, Inc., of La Canada, California, which produces "Zeke's Floatin' Bait." This bait has a base of processed cheese to which is added certain artificial ingredients which make the cheese easier to thin and mix and which give the bait its floatation characteristics.

Effective date

The bill would apply with respect to sales made after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by a negligible amount.

7. S. 2239—Senators Packwood, Nelson, and Cranston

Incentive Stock Options

Present law

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by the rules of section 83 of the Internal Revenue Code. Generally, under section 83, the value of the option constitutes ordinary income to the employee if the option itself has a readily ascertainable fair market value at the time it is granted to the employee. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at the time granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee. Personal service income is generally taxed at a maximum rate of 50 percent.

In addition, the employer generally is allowed a business expense deduction in the amount includible in the employee's income in its corresponding taxable year (Code sec. 83(h)).

Background of tax treatment of stock options

Restricted stock options

The Revenue Act of 1950 added provisions for the use of a "restricted stock option" under which no income tax was imposed either when the option was granted or exercised. Instead, tax generally was imposed at the time the stock involved was sold by the employee. In the case of those restricted stock options where the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time he sold the stock was treated as capital gain. Where the stock option price was between 85 and 95 perecnt of the market price at the time the option was granted, the difference between the option price and the market value of stock at the time of the grant of the option was treated as ordinary income when the stock was sold. Any additional gain at the time the stock was sold in such cases was treated as capital gain. In the case of these restricted stock options, employers were not allowed any deduction for the amount of the gain realized by the employee, whether this gain was treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must have been at least 85 percent of the market price of the stock at the time the option was granted; the stock and/or the option must have been held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it was transferred to him; the option must not have been transferable other than at death; the individual may not have been a 10-percent shareholder in the corporation (unless the option price was at least 110 percent of the fair market value); and the option must not have been for a period of more than 10 years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock option provisions and added provisions allowing so-called "qualified stock options".

These qualified stock options were taxed in a manner similar to restricted stock options. These options, however, must have been granted with an option price of at least the market price when the option was granted (subject to a 150-percent tax where a good faith attempt to meet this requirement failed).

In addition, qualified stock options were subject to the additional rules that the stock must be held 3 years or more; the option may not have been held more than 5 years; stockholders' approval must have been obtained: the options must have been exercised in the order granted; and no option may have been granted to shareholders owning more than 5 percent of the stock (increased up to 10 percent for corporations with less than $2,000,000 equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 added a minimum tax under which a tax was imposed equal to 10 percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added. However, the income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options, etc.

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976, (except for certain transitional options which will cease to be qualified after May 20, 1981). This Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, the taxes on capital gains were reduced so that the maximum rate of tax on these gains is 28 percent.

Issue

The issue is generally whether Congress should reinstitute a stock option provision under which an employee may be granted an option to buy his employer's stock and be taxed at capital gains rates at the time he or she sells the stock.

Explanation of the bill

The bill would create an "incentive stock option", which would be subject to taxation in a manner similar to the tax treatment previously available to restricted and qualified stock options—i.e., there would be no tax consequences at the time the option is exercised, and the employee would be eligible for capital gain treatment when the stock is sold.

For an option to qualify as an "incentive stock option"; (1) the exercise price must be not less than fair market value of the stock at the time the option is granted (in the case of a variable option, determined as if the option had been exercised when granted); (2) the option must be exercised within 10 years of the date granted; (3) shareholder approval is required; (4) the individual may not be an employee owning more than 10 percent of the value or voting power of stock of the company (unless the option price is at least 110 percent of the stock's fair market value); (5) the optionee must be an employee continuously from grant of the option to 3 months prior to exercise; (6) the option may be transferred only at death; and (7) the stock must be held for at least 2 years after the date of the granting of the option and for at least one year after the option is exercised.

Effective date

The provisions of the bill would apply to options granted after the date of enactment of the bill.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $2.5 million per year in fiscal years 1980–1983, and would increase budget receipts by $15 million in fiscal 1984 and $30 million in fiscal 1985.

8. S. 2367—Senator Boren

Gain on Sale of Stock of Foreign Investment Company

Present law

In general, gain on the sale of stock in a foreign corporation which is a foreign investment company is treated as ordinary income to the extent of the selling shareholder's portion of its earnings and profits. A foreign investment company is defined as an foreign corporation controlled by U.S. persons which is registered under the Investment Company Act of 1940 or which engages in certain investment activities specified in that Act.

Ordinary income treatment applies to the extent of the earnings and profits attributable to the period of time (after 1962) during which the stock was held by the selling shareholder (even if the corporation was a foreign investment company for only part of that period). Thus, for example, the U.S. shareholders of a foreign corporation which was organized in 1963, which engaged in activities which made it a foreign investment company for only one year, say, 1970, and which liquidated in 1980, would be taxed under section 1246 as though the corporation were a foreign investment company for the entire 17 years rather than just the one year.

Issue

The issue is whether gain from the sale of stock in a foreign corporation attributable to earnings and profits from the period before the corporation became a foreign investment company should be treated as ordinary income.

Explanation of the bill

The bill would provide that gain on the sale of a foreign corporation's stock will not be taxed under Code section 1246 with respect to earnings and profits of the corporation attributable to years before the corporation is a foreign investment company. This treatment would prevent gain attributable to active business operations from being taxed under the foreign investment company provisions if the corporation subsequently becomes a foreign investment company. In most cases, this would result in treatment of the gain as capital gain. However, if the corporation has been a controlled foreign corporation, part of the gain might be treated as a dividend (Code sec. 1248).

Effective date

The bill would apply to sales or exchanges after the date of enactment of the bill in taxable years ending after that date.

Revenue effect

It is estimated that this bill would reduce budget receipts by $5 million in fiscal year 1981 and by less than $1 million annually in later years.

9. S. 2396—Senator Jepsen

Treatment of Certain Finance Companies as Personal Holding Companies

Present law

Code section 541 imposes a 70-percent tax on the undistributed personal holding company income of a personal holding company. This provision is intended to prevent individuals from avoiding the graduated individual tax rates (ranging up to 70 percent) by placing investments in corporations which are subject to a maximum tax rate of 46 percent.

A personal holding company is defined as a corporation 60 percent of whose adjusted ordinary gross income is personal holding company income and 50 percent of whose stock is owned by 5 or fewer shareholders at any time during the last half of the taxable year. Personal holding company income generally is defined as interest, dividends, royalties, rents and certain other types of passive investment income.

Certain types of corporations which are actively engaged in a trade or business which produces income which usually would be considered to be passive investment income are excluded from the personal holding company tax provisions. Among the corporations excluded from these provisions are lending or finance companies. A corporation qualifies as a lending or finance company if 60 percent of its ordinary gross income is derived from the active and regular conduct of a lending or finance business and certain other requirements are satisfied. The term lending or finance business is defined, in part, to mean a business of making loans, and purchasing or discounting accounts receivable, notes, or installment obligations which at the date of acquisition have a remaining maturity of no more than 60 months. One exception to the 60-month rule is provided for loans, notes, or obligations secured by a security interest in personal property where the security interest arose out of the sale of goods or services in the course of the borrower's or transferor's trade or business.

The personal holding company provisions also apply a business expense test in determining whether a corporation is engaged in the active and regular conduct of a lending or finance business. Under this requirement a corporation will not qualify as a lending or finance company exempt from the personal holding company provisions unless the sum of its business expenses directly allocable to its lending or finance business equals or exceeds 15 percent of the first $500,000 of its ordinary gross income derived from a lending or finance business plus 5 percent of such ordinary gross income from $500,000 to $1,000,000.

Issues

The issues are (1) whether the definition of the term lending or finance business should be modified to include the business of making revolving credit loans and loans with maximum maturities of 144 months; and (2) whether the business expense test of present law should be modified.

Explanation of the bill

The bill in general would modify the 60-month maturity limitation under the definition of a lending or finance business and the business expense requirement of the lending or finance company exception to the personal holding company provisions. Under the bill, the definition of a lending or finance business would be amended to include the business of making loans with maturities up to 144 months and to include the business of making certain types of revolving credit loans.

Revolving credit loans qualifying under the bill would be such loans made under an agreement which provides that the creditor will make loans or advances (not in excess of an agreed upon maximum amount) from time to time for the account of the debtor upon request and which provides that the debtor may repay the loan or advance in full or in installments.

The bill would also remove the current cap on the amount of business expenses required in determining whether a corporation is a lending or finance company. Under the bill, a corporation would satisfy the business expense test only if its qualifying business expenses equal or exceed 15 percent of its ordinary gross income up to $500,000 derived from a lending or finance business, plus 5 percent of such ordinary gross income in excess of $500,000.

Effective date

The bill would apply to taxable years beginning on or after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $5 million.

10. S. 2415—Senator Packwood

Qualification of Leased Furniture for the Investment Tax Credit

Present law

Under present law, certain depreciable property used by a taxpayer in the taxpayer's trade or business and placed in service during the tax year is eligible for the investment tax credit (Code secs. 38, 48).

Specifically excluded from eligibility for the credit is property used predominantly to furnish lodging or in connection with the furnishing of lodging unless the property consists of coin-operated machines (vending machines, washing machines, dryers), or property used by a hotel or motel, or a non-lodging commercial facility which is open to the general public and located in a lodging facility (Code sec. 48) (a) (3)). Thus, for example, most of the property used in an apartment house or dormitory, including lobby furniture and office equipment, will not qualify for the credit.[1]

Recently, a district court held that a taxpayer in the business of leasing furniture to apartment building owners and to tenants of apartment buildings was denied the credit for furniture leased to the apartment building owners because the property was used in connection with the furnishing of lodging, but permitted the credit for furniture leased directly to tenants.[2] The position of the Internal Revenue Service is that the credit is also not allowable with respect to furniture leased to tenants.[3]

Issue

The issue is whether furniture purchased by a person who is engaged in the business of furniture rental or leasing to others should be qualified for the investment credit, irrespective of whether the lessee of such furniture uses it in connection with the furnishing of lodging or for any other use.

Explanation of the bill

Under the bill, furniture purchased by a person who is engaged in the trade or business of furniture rental or leasing to others would qualify for the investment tax credit, irrespective of how the lessee uses the property.

Effective date

The provisions of the bill would apply for all taxable years ending on or after August 15, 1971 (the general effective date for the reinstatement of the investment tax credit by the Revenue Act of 1971).

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[1] Treas. Regs. § 1.48–1(h) (1) (ii).

[2] *Aaron Rents, Inc.* v. *United States*, 78–2 USTC ¶ 9727, 42 AFTR 2d 78–5940 (N.D. Ga. 1978).

[3] Rev Rul. 78–438, 1978–2 C.B. 10.

However, no provision is made by the bill to open taxable years with respect to which credits or refunds are barred by the statute of limitations under section 6511.

Revenue effect

It is estimated that this bill would reduce budget receipts by $1 million in fiscal year 1980, $6 million in 1981, including prior years' liability, $2 million in 1982, $3 million in 1983, and $4 million in fiscal years 1984 and 1985.

11. Section 4 of H.R. 5973

Special Rule Relating to Debt-Financed Income of Exempt Organizations

Present law

Generally, any organization which is exempt from Federal income tax (under Code sec. 501(a)) is taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; it is not taxed on passive investment income or income from any trade or business which is related to the organization's exempt purposes.[1]

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase money obligations to be repaid out of tax-exempt profits, for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt. In general, debt-financed property is defined as "any property which is held to produce income and with respect to which there is acquisition indebtedness" (Code sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property 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.[2]

The provisions relating to unrelated debt-financed income generally applied to taxable years beginning after December 31, 1969.[3] The 1969 Act provided a transitional rule under which the Clay Brown rules were to apply only where indebtedness had been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966) until taxable years beginning after 1971. After the transition period, the new rules were applicable to all situations of investment borrowing by exempt organizations.

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[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (Code sec. 501(c)(7)) and voluntary employees beneficiary associations (Code sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 2 percent on their net investment income.

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

[3] However, in extending the unrelated debt-financed income rule and other rules relating to the unrelated business income tax to churches, the 1969 Act provided that these provisions did not apply to churches for taxable years beginning before January 1, 1976.

Issue

The issue is whether a limited exception to the debt-financed income rules should be provided for income derived from certain sales of real property during 1976 in situations where the indebtedness was incurred prior to 1965.

Explanation of the bill

The bill would provide a very limited exception to the debt-financed income rules. Under this exception, it is provided that, in applying the debt-financed income rules to any sale of real property during 1976, indebtedness incurred before January 1, 1965, by an organization to finance the construction of a building on such property shall not be treated as acquisition indebtedness if the parcel of real property on which the building was constructed (1) was acquired by the organization before January 1, 1952, and (2) is contiguous to another parcel of real property which (*a*) was acquired by the organization before January 1, 1952, and (*b*) was used by the organization for exempt purposes (for the entire period from January 1, 1952, until the date of enactment of the bill).

Although this provision may possibly benefit other taxpayers, it is primarily intended to provide tax-free treatment for a 1976 sale of real property by the Tillamook County Young Men's Christian Association (YMCA), Tillamook, Oregon. The real property sold by the Tillamook YMCA was property adjacent to property it used for carrying on its charitable and educational purposes.

Effective date

This provision would apply only to certain sales of real property during calendar year 1976.

Revenue effect

It is estimated that this provision would result in one-time reduction in budget receipts of less than $50,000 in fiscal year 1980.

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