[COMMITTEE PRINT]

# DESCRIPTION OF TECHNICAL AND MINOR BILLS LISTED FOR A HEARING BY THE COMMITTEE ON WAYS AND MEANS ON DECEMBER 10, 1975

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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# I. INTRODUCTION

The technical and minor bills described in this pamphlet are those on which the Committee on Ways and Means has announced a one-day public hearing for Wednesday, December 10, 1975.

The bills for consideration in this hearing were compiled from a list submitted by the members of the Committee on Ways and Means. The bills submitted were reviewed by a special screening committee of committee members in order to determine whether the bills met the criteria of being technical or minor bills. The fact that a bill appears on the list, or has been deleted, does not indicate any view of the members of the screening committee as to the proposed legislation. The criteria used by the screening committee in determining whether a bill should be included for this hearing are as follows:

1. The bill must not involve a significant revenue loss (generally, not more than $5 million full year effect; outside limit would be $15 to $20 million).

2. The bill must not involve a broad structural or major administrative change in the tax laws.

3. The bill must not have been included as a provision in the tax reform bill (H.R. 10612).

4. The bill must not have been referred to a study committee during the consideration of the tax reform bill (H.R. 10612).

5. The bill must not deal with an area specifically listed for consideration in phase II.

In connection with the hearing referred to above, the staff of the Joint Committee was directed to prepare a description of the bills, to indicate whether any of the bills are retroactive, and to name any particular taxpayer to which the bill might be directed to the extent of the staff's information.

This pamphlet was prepared by the staff to meet the directions set out above. The pamphlet first briefly summarizes the bills. This is in order of bill number. This is followed by a more detailed description of each bill indicating in each case the present law treatment, the issue involved, an explanation of what the bill would do, any prior committee or congressional consideration of the bill, the effective date of the provision, the revenue effect of the provision, and departmental positions with respect to the bill.

# II. SUMMARY

## 1. H.R. 1142—Mr. Waggonner

### Tax Treatment of Cemetery Perpetual Care Fund Trusts

The bill provides a special deduction in computing the income of a cemetery "perpetual care fund" for amounts expended by the fund for the care and maintenance of cemetery property in which internment rights have been sold. The "perpetual care fund" to which this bill pertains is an irrevocable trust established pursuant to local law by a taxable cemetery for the care and maintenance of the cemetery. The deduction allowed is to be the lesser of the amount actually distributed during the year for such care and maintenance or $5 per gravesite.

## 2. H.R. 1144—Mr. Waggonner

### Tax Treatment of Social Clubs and Other Membership Organizations

This bill deals with the requirements for tax exemption for social clubs and similar organizations (including college fraternities and sororities). Presently, in order to qualify as tax exempt, these organizations must be organized and operated "exclusively" for pleasure, recreation, and other nonprofitable purposes and no part of their net earnings may inure to the benefit of any private shareholder. The bill substitutes for this exclusive operation requirement the requirement that "substantially all" of the organization's activities must be for these purposes. The effect of this change is to allow a club to earn income from nonmember sources to a limited extent, and to have a limited amount of investment income without losing its exempt status.[1]

It is intended by this change to permit groups to receive up to 25 percent of their gross receipts (including investment income) from sources outside of their membership without losing their exempt status so long as they do not derive more than 15 percent of their gross receipts from the use of their facilities by the general public. However, this income from nonmembers, and also the investment income, still remains subject to income tax. In addition, these changes are not intended to permit such an organization to maintain its exemption and carry on a business which is not related to its membership activities.

The bill also resolves a question about whether the corporate dividends received deduction is available to those organizations which are generally exempt but which nevertheless are taxed on their investment income. It disallows this deduction in computing the taxable invest-

[1] Under the present position of the Internal Revenue Service (Rev. Proc. 71–17, 1971–1 C.B. 683), the exempt status of a social club will not be changed if the club's annual income from outside sources is not more than $2,500 or is not more than 5 percent of the total gross receipts of the organization. If the gross receipts from nonmember sources exceed 5 percent, then all the facts and circumstances are taken into account to determine whether the organization continues to qualify for exemption.

ment income of social clubs and employee beneficiary associations. Similarly, the bill denies the dividends received deduction for investment income of taxable membership organizations.

### 3. H.R. 2474—Mr. Schneebeli

### Refunds in the Case of Certain Uses of Tread Rubber and Tires

This bill would provide a credit or refund of the manufacturers excise tax on tread rubber where tax-paid tread rubber is (1) wasted in the recapping or retreading process, (2) used in the recapping or retreading of tires the sale of which is later adjusted, or (3) used in the recapping or retreading of tires which are exported, are sold to State or local governments, are sold to nonprofit educational institutions, or are sold as supplies for vessels or aircraft. The bill would provide for tread rubber under these circumstances the same tax treatment now provided for new tires. Also, the bill would clarify the treatment of credits or refunds in the case of new tires the sale of which is later adjusted as the result of a warranty or guaranty by requiring that the credit be proportionate to the adjustment in price of the tire returned.

### 4. H.R. 2984—Mr. Conable

### Treatment of Payment or Reimbursement of Government Officials for Expenses of Foreign Travel by Private Foundations

This bill would broaden an exception to the present rules prohibiting self-dealing between private foundations and disqualified persons. Under present law, the payment or reimbursement of expenses of Government officials by a private foundation generally is classified as an act of self-dealing and is prohibited. However, a limited exception to this rule permits a private foundation to pay or reimburse certain expenses of Government officials for travel solely within the United States. This bill would permit private foundations to pay or reimburse Government officials for expenses of foreign travel under the same type of limitation as in the case of expenses for domestic travel.

### 5. H.R. 3052—Messrs. Rostenkowski and Schneebeli

### Treatment of Option Lapse Income of Exempt Organizations

H.R. 3052 deals with the application of the unrelated business income tax to income which an exempt organization receives from writing options to buy or sell securities in cases where the option is allowed to lapse, or is terminated. Under present law, premiums received for options which are exercised are treated as part of the gain or loss on the sale of the property involved—that is, usually as capital gain or loss. However, premiums for options which are allowed to lapse or are terminated generally are treated as ordinary income. In the case of most exempt organizations, capital gains—which include premiums from "exercised" options—are excluded from the unrelated business income tax as a part of the general exclusion for these organizations' investment income. In addition, most tax exempt organizations are not taxed on dividend or interest income. This bill adds income from the lapse or termination of options to buy or sell securities to the exempt category of income for exempt organizations (except for those categories of organizations taxed on investment income). This bill does not change the treatment of exercised options.

### 6. H.R. 3055—Mr. Rostenkowski

### Distilled Spirits

The bill consists of a series of technical and administrative provisions, which may be summarized as follows: It—

(1) eliminates the requirement that the name of the distiller be placed upon gin or vodka bottled in bond for export;

(2) extends to imported distilled spirits packaged or bottled in the United States for export the same tax benefits given to domestically produced spirits packaged or bottled for export;

(3) allows distilled spirits to be returned to bonded premises of distilled spirits plants or to export storage facilities, with benefit of tax credit or refund, etc., for storage pending exportation and certain other preferred dispositions recognized in sections 5214(a) and 7510 of the Code;

(4) allows spirits bottled in bond, or returned to an export storage facility, for export, to be transferred without payment of tax to customs bonded warehouses for storage pending exportation;

(5) allows spirits to be withdrawn from bonded premises without payment of tax for purposes of research, development, or testing;

(6) relaxes the conditions under which bonded spirits may be mingled;

(7) allows gin to be made with the extracted oils of juniper berries and other aromatics, as well as with the juniper berries or other aromatics themselves, without payment of the rectification tax; and

(8) enables taxes on distilled spirits brought into this country from Puerto Rico or the Virgin Islands to be abated, remitted, credited, or refunded in appropriate cases of loss or voluntary destruction just as are the taxes imposed on domestic distilled spirits.

### 7. H.R. 3605—Mr. Pickle

### Reduction in Beer Tax for Small Brewers

The bill provides a limited reduction in the excise tax on beer for small brewers. Present law imposes a $9 per barrel excise tax on beer produced or imported in the United States. The bill provides a $2 per barrel tax reduction to $7 per barrel on the first 60,000 barrels of beer produced each year by a domestic brewer who produces annually no more than 2 million barrels of beer. The bill is designed to enable small domestic brewers to compete more effectively against the large national breweries.

### 8. H.R. 5071—Mr. Conable

### Maintenance of Common Trust Fund by Affiliated Banks

This bill modifies the rules relating to the maintenance of common trust funds and banks. Under present law a bank may maintain a common trust fund (the income of which is taxed to the participants rather than it being taxed as a corporation) for the collective investment and reinvestment of moneys transferred to the bank in its fiduciary capacity. The Internal Revenue Service has taken the position

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that a fund which accepts contributions from other banks acting in a fiduciary capacity (even though the banks are affiliated) will not qualify as a common trust fund. This bill provides that where banks which are members of the same affiliated group establish a combined common trust fund, this fund is to be treated as a "common trust fund" for tax purposes during the period of the affiliation.

### 9. H.R. 5161—Mr. Corman

### Tax Treatment of Magazines Used for Display Purposes

The bill provides that a magazine publisher or distributor may elect to include in income sales of periodicals for display purposes in the taxable year in which he finally accounts for returns of the periodical. This provision only applies to returns of periodicals which are made by the due date of the corporate tax return. A sale is made for display purposes if the sale is made in order to permit an adequate display of the magazine and if at the time of the sale the publisher or distributor has a legal obligation to accept returns of the magazine.

### 10. H.R. 6521—Mr. Duncan

### Exemption From Tax on Farm Trailers and Horse Trailers

The bill would provide an exemption from the 10-percent manufacturers excise tax for trailers or semitrailers suitable for use with "light-duty" towing vehicles, but only if they are designed to be used for farming purposes or for transporting horses or livestock. Sales of parts or accessories for these exempted articles would also be exempted by the bill.

### 11. H.R. 7228—Mr. Duncan

### Devices Other Than Stamps on Distilled Spirits Containers as Evidence of Tax Payment

The bill relates to the means used as evidence of tax payment for containers of distilled spirits. Under present law, containers of distilled spirits must have a stamp as evidence of the payment of the Federal excise tax. The bill permits the Treasury Department to authorize the use of means other than stamps as evidence of this tax payment. The bill also allows the Secretary of the Treasury to authorize persons outside the Treasury Department to prepare and distribute the stamps or other devices that may be used, which will be done only under controls necessary to protect Federal revenues.

### 12. H.R. 8046—Mr. Duncan

### Exclusion From Income of Rental Value of Parsonage Furnished to Surviving Spouse of Minister

The bill deals with the tax treatment of the rental value of a home or housing allowance furnished to the surviving spouse of a minister of the gospel. Under present law, a minister of the gospel is entitled to exclude from his gross income the rental value or the allowance paid to him for housing which is part of his compensation. The bill would extend this treatment to the surviving spouse of the minister.

### 13. H.R. 8125—Mr. Burke

**Revision of Tax Structure on Large Cigars From Bracket System to an Ad Valorem Tax**

The bill changes the present bracket system of taxing cigars on the basis of their intended retail price to a single ad valorem tax of 8½ percent of the intended wholesale price. The bill defines intended wholesale price as the manufacturer's or importer's suggested price at which cigars are to be sold to retailers.

### 14. H.R. 8283—Mr. Corman

**Types of Flavors Permitted To Be Used in the Production of Special Natural Wines**

The bill deals with the type of flavors which may be used on bonded and cellar premises in the production of special natural wines. Under present law, flavors other than natural flavors are not permitted to be used in the production of special natural wines. The bill permits flavors other than natural flavors, subject to the approval by the IRS, to be used in the production of special natural wines.

### 15. H.R. 9889—Mr. Burke

**Extension of Time To Amend Governing Instruments of Certain Charitable Remainder Trusts**

The bill extends the period of time to allow charitable remainder trusts to conform to the requirements provided in the Tax Reform Act of 1969 for purposes of an estate tax deduction. Present transitional rules allow a trust created after July 31, 1969, to qualify as a charitable remainder trust for purposes of the estate tax deduction if the governing instrument of the trust is amended to meet these requirements by December 31, 1975. This bill extends the period 2 additional years through 1977.

### 16. H.R. 10051—Mr. Waggonner

**Treatment of Returned Inadvertent Distributions of Life Insurance Companies**

The bill deals with the tax treatment of certain income of a life insurance company where tax on such income would otherwise be deferred under present law but for an inadvertent distribution of the income to the shareholders of the company. The bill generally permits deferral of tax only if the amount distributed to the shareholder is repaid to the insurance company no later than the time the insurance company's tax return for the year of the distribution is due. The deferral would only be allowed if the distribution was inadvertent, that is, where it was made without the intent to have the distribution returned to the company so as to qualify for the continued deferral provided by the bill.

A shareholder's tax basis for computing gain or loss with respect to his stock in the insurance company would not be affected by the distribution or repayment to the extent a dividends deduction or exclusion is allowable with respect to the distribution.

### 17. H.R. 10101—Mr. Pickle

**Exemption From Fuel and Use Excise Taxes for Certain Aircraft Museums**

There are presently in the United States several aircraft museums which own and display vintage aircraft to the public at airshows and exhibitions. The fuel used by these aircraft is subject to the present Federal excise tax on fuel of 7 cents per gallon. In addition, the aircraft are subject to Federal aircraft use taxes which are largely based upon the weight of the aircraft.

The bill exempts from the fuel and use taxes certain tax-exempt, State-chartered aircraft museums which operate exclusively to obtain, maintain and exhibit aircraft of the type used for combat or transport in World War II.

### 18. H.R. 10155—Mr. Vander Veen

**Tax Treatment of Certain Income of Political Organizations**

The bill deals with the tax treatment of income of political organizations. Under present law, a political organization is generally subject to tax on income from investments and income from any trade or business. However, contributions, membership fees, and proceeds from a political fund raising or entertainment events and proceeds from political campaign materials, not in the course of a trade or business, are exempt from tax.

The bill expands the exemptions to include proceeds of a political organization from any trade or business in which substantially all the work is performed without compensation.

### 19. H.R. 10902—Mr. Green

**Tax Treatment of Securities Acquired for Business Reasons and Not as an Investment**

The bill deals with the tax issue as to whether securities are acquired for business reasons or for investment purposes. In general, present law provides that gain or loss on the sale or exchange of a security held for investment purposes is treated as a capital gain or loss which a security held for business purposes is treated as ordinary income or loss. The bill provides that a taxpayer may only treat a loss on the sale or exchange of a security as ordinary loss (rather than as a capital loss) if he notifies the Internal Revenue Service within 30 days after he acquires the security that he did not make the acquisition as an investment. Where this notice is filed, the taxpayer will realize ordinary gain (rather than capital gain) if the security is later sold or exchanged at a gain.

### 20. H.R. 10926—Mr. Karth

**Treatment of Face-Amount Certificates**

This bill deals with the treatment of original issue discount attributable to "face-amount certificates." Under the bill, the amount of discount attributable to face-amount certificate is not to be ratably included in the gross income of the holder each year over the term of the certificate. Instead, it will be included in the gross income of the holder upon actual receipt.

### 21. H.R. 10936—Mr. Gibbons

### Recapture as Ordinary Income of Property for Which a Business Expense Deduction Was Allowed

This bill provides that where a deduction has been claimed at the time of the first use of property, any gain realized on the subsequent sale or exchange of that property is to be subject to recapture as ordinary income (to the extent of the amount of the deduction) in the same manner as in the case of depreciable tangible property.

### 22. H.R. 11006—Mr. Jones

### Postponement of Time for Paying Excise Tax in the Case of Fishing Equipment

This bill would allow manufacturers, producers and importers of fishing equipment and related accessories to postpone payment of the excise taxes pertaining to the sale of these items until the time of receipt of payment from the purchaser, but no later than eight months after the date of the sale.

## III. DESCRIPTION OF BILLS

### 1. H.R. 1142—Mr. Waggonner

### Tax Treatment of Cemetery Perpetual Care Fund Trusts

*Present law*

The position of the Internal Revenue Service is that perpetual care fund trusts established by a taxable cemetery are subject to tax.[1] The Service also has held that the deduction for income distributed to beneficiaries of trusts (under secs. 651 and/or 661) is not to be allowed to perpetual care funds because they do not have any specific beneficiaries. The Service's position in this regard is that the benefit of the trust is diffused among the owners of the lot, the cemetery companies, and the public in general.

However, in a recent and related case, *Graceland Cemetery Improvement Fund* v. *U.S.*, 515 F. 2d 762 (Ct. Cl. 1975), the Court of Claims held that a corporation formed for the perpetual care of a taxable cemetery was entitled to deduct as ordinary and necessary business expenses all payments made for cemetery care and upkeep.

*Issue*

The issue is whether perpetual care fund trusts established by taxable cemeteries should be entitled to a deduction for the amounts expended for the care and maintenance of gravesites of such cemeteries.

*Explanation of bill*

The bill amends the trust provisions (sec. 642) of present law to provide a deduction for those amounts expended by perpetual care fund trusts for the care and maintenance of gravesites. The deduction allowed is to be the lesser of the amount actually distributed during the year for such care and maintenance or $5 per gravesite. Since perpetual care funds are established for the care of gravesites that have been previously sold by cemetery corporations, the deduction is to apply only for amounts expended for the care of gravesites sold before the taxable year in question. For the same reason, the deductions are to be available only with respect to the care and maintenance of gravesites with respect to which the fund actually has an obligation of care.

The bill would have the effect of eliminating the taxable income of substantially all of these perpetual care fund trusts since the deduction provided by the bill in almost all cases is more than is usually needed to provide for the care and maintenance of the gravesites.

This bill has been requested by the cemetery associations. A statement was submitted to the committee on behalf of the American

[1] In Rev. Rul. 64–217 (1964–2 C.B. 153), the Service held that a perpetual care fund, the income of which is turned over to a profit-making cemetery company for use in connection with the maintenance of cemetery sites and burial lots, is not entitled to exemption from Federal tax.

Cemetery Association, the National Association of Cemeteries, the Southern Cemetery Association, and the Western Cemetery Alliance. The membership of these associations include municipal, fraternal, religious, community nonprofit, and private cemeteries situated throughout the United States.

*Prior committee action*

In the 93rd Congress, the committee included an identical provision in its tax reform bill of 1974.

*Effective date*

The amendment is retroactive and applies to amounts distributed during taxable years ending after December 31, 1963, which is when the Service first gave public notice of its position regarding the tax treatment of perpetual care funds of profit-making cemeteries.

*Revenue effect*

The estimated annual revenue loss is $10 million. The revenue effect pertaining to taxable years ending after December 31, 1963, and beginning before January 1, 1976, cannot be estimated with any degree of accuracy. In any event, it is understood that the Internal Revenue Service has not been imposing any tax in these cases in the past which means that the bill in effect would forestall any revenue collections for the prior years.

*Departmental position*

The Treasury Department has expressed support for this bill in previous reports on bills in prior congresses (with certain modifications which are contained in this bill).

## 2. H.R. 1144—Mr. Waggonner

### Tax Treatment of Social Clubs and Other Membership Organizations

*Present law*

*Income from nonmembers and investment sources.*—Among the present law categories of exempt organizations are social clubs and other somewhat similar nonprofit organizations, such as national organizations of college fraternities and sororities. Present law (sec. 501(c)(7)) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofit purposes with no part of the net earnings inuring to the benefit of any private shareholder. The regulations under this provision state that a club which engages in business is not organized and operated exclusively for nonprofitable purposes and, therefore, is not exempt.

Generally, the Internal Revenue Service has not challenged the exempt status of these organizations if the income derived from providing goods and services to persons other than members and their guests is small in relation to the total activities of the organization. Thus, as an audit standard (Rev. Proc. 71-17, 1971-1 C.B. 683) the Service has indicated that it generally will not disturb a social club's exempt status solely on the basis of its nonmember activities if the club's annual income from outside sources is not more than the higher of $2,500 or 5 percent of the total gross receipts of the organization. Where gross receipts from nonmember dealings exceed this 5-percent figure, all facts and circumstances are taken into account in determining whether the organization continues to qualify for exempt status. In the case of investment income, the Service applies no percentage rule, but instead looks to whether a substantial part of the club's income is from investment sources (Rev. Rul. 66-149, 1966-1 C.B. 146).

In the Revenue Act of 1950, Congress imposed the regular income tax on the income certain tax-exempt organizations receive from active business enterprises which are unrelated to their exempt purposes in order to prevent such tax-exempt organizations from enjoying a competitive advantage over other businesses. Social clubs, national organizations of college fraternities and sororities, and certain other tax-exempt organizations were not subjected to the unrelated income tax imposed at that time.

In the Tax Reform Act of 1969, however, Congress extended the unrelated business income tax to virtually all of the exempt organizations not already subject to that tax because many of the exempt organizations not subject to the unrelated business income tax were engaging in substantial business activity. As a result, social clubs and national organizations of college fraternities and sororities are subject to tax on all of their unrelated business income.

In addition, the 1969 Act extended the regular income tax in the case of these social clubs and employees' beneficiary associations to cover



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investment income as well as the unrelated business income. Investment income was made taxable in the case of these membership organizations because not to do so would have permitted them to provide recreational or social facilities and services out of income other than membership fees, and as a result, would have allowed individuals to devote investment income, free of tax, to personal activities.

*Dividends received deduction for exempt social clubs, etc.*—Generally, under present law the tax on unrelated business income does not apply to investment income.[1] However, in the case of social clubs and employee beneficiary associations, "investment income" is included in the tax base. This result is accomplished in the case of these organizations by defining their unrelated business taxable income (sec. 512(a)(3)) as gross income (other than exempt function income) less allowable deductions directly connected with the production of gross income (again excluding exempt function income).[2]

One of the deductions allowed corporations in the computation of the regular corporate income tax is the dividends received deduction. Generally, this allows corporations a deduction equal to 85 percent of dividends received from taxable domestic corporations. The proposed Treasury regulations on social clubs and employee beneficiary associations[3] provide that the dividends received deduction is not allowed for purposes of computing the unrelated business taxable income for social clubs and employee beneficiary associations, because it is not an expense directly connected with the production of income.

*Dividends received deduction for nonexempt membership organizations.*—The third section of the bill also relates to the dividends received deduction in the case of investment income, but in this case where the dividends are received by nonexempt membership organizations. The Tax Reform Act of 1969 (sec. 277 of the code) provided that in the case of taxable membership organizations the deduction for expenses incurred in supplying services, facilities, or goods to the members was to be allowed only to the extent of the income received from these members. This was provided in order to prevent taxable membership organizations from escaping tax on business or investment income by using this income to provide services, facilities, or goods to its members at less than cost and then deducting the loss from the membership activity against the investment income.

*Issues*

*Income from nonmembers and investment sources.*—Social clubs and similar organizations are currently faced with the loss of their tax-exempt status if they receive any income from nonmember sources or from investments. Because of the personal nature of social clubs and employee beneficiary associations, the Internal Revenue Service prior to the 1969 Act had developed the 5-percent test discussed above for determining whether a social club was properly exempt from tax. Not to have significantly limited the income which could be derived from nonmembers, under the conditions prevailing at that time, would have allowed members of these clubs to devote nontaxed income to their personal benefit.

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[1] Sec. 512(b) specifically excludes from the term "unrelated business taxable income" passive investment income such as dividends, interest, royalties, and capital gains.

[2] Exempt function income is defined in sec. 512(a)(3)(B) as gross income from dues, fees, charges, or similar amounts paid by members in connection with the purposes constituting the basis for the exemption of the organization.

[3] Proposed Reg. § 1.512(a)–3(b)(2) published on May 13, 1971.

However, since the passage of the 1969 Act, the clubs have contended that such a strict line of demarcation between the exempt and nonexempt activities of social clubs is not necessary. They point out that since 1969, all of the income derived from nonmembers, as well as investment income, is subject to tax, even though the organization itself is still classified as an exempt organization. Therefore, the issue is whether some modification of existing law is appropriate to permit exempt social clubs to derive a somewhat larger amount of income from nonmembers and also from investment income sources.

*Dividends received deduction for exempt social clubs, etc.*—Those favoring a denial of the dividends received deduction point out that members of these exempt organizations, as well as members of similar taxable organizations, receive a tax benefit unavailable to other taxpayers because these exempt and taxable organizations are entitled to the corporate dividends received deduction. They point out that through such organizations, members can devote dividend income to their personal, social and recreational pursuits without paying the "second-level" individual income tax which nonmembers must pay on their personal dividend income.

In addition, questions have been raised with respect to the proposed Treasury regulations which deny the dividends received deduction to exempt social clubs and similar organizations although Congress had not expressly disallowed the deduction. To clarify this point, the Treasury Department has requested Congress to state specifically that the dividends received deduction is not available in the case of investment income of tax-exempt social clubs and employee beneficiary associations.

The major reason for the dividends received deduction is to avoid two or more corporate taxes on corporate earnings as the income is passed from one corporation to another, in addition to taxing the same amount to individual shareholders when the earnings are paid out as dividends to them. In the case of social clubs and employee beneficiary associations, however, the argument is made that the tax benefit is received because the dividend income received by the exempt organizations is not distributed to the members and, thus, the individual income tax is inapplicable.

The proposed Treasury regulations disallowing the dividends received deduction allows deductions in the case of investment income of social clubs and employee beneficiary associations but only in the case of deductions directly connected with the production of income. The issue is whether or not to clarify this matter by providing that in the case of such organizations the dividends received deduction is not to be considered as directly connected with the production of gross income.

*Dividends received deduction for nonexempt membership organizations.*—To the extent that taxable membership organizations receive dividend income which is used to provide services, facilities, or goods to the members, the same problem arises in connection with these organizations as in the case of the tax-exempt membership organizations referred to above. It is pointed out that if the dividends received deduction were available in the case of the tax on the membership organization (in effect a substitute for the dividend tax on shareholders) the second, or individual, tax on this income would be avoided in substantially the same way as in the case of the exempt membership organizations (were the provision described above not to be added). Moreover, if nothing were done in this regard in the case of taxable membership organizations the tax-exempt organizations by revoking their exempt status could avoid the tax on this dividend income in this manner.

Therefore, the issue with respect to this point is whether the dividends received deductions should be disallowed in the case of these taxable membership organizations in the same manner as in the case of the tax exempt membership organizations referred to above.

*Explanation of the bill*

*Income from nonmembers and investment sources.*—The first amendment made by the bill (subsection (a) of the bill) substitutes for the present law requirement that clubs which are exempt from tax under sec. 501(c)(7) must be organized and operated "exclusively" for pleasure, recreation, and other nonprofitable purposes, the requirement that "substantially all" of such a club's activities must be for these purposes.[4]

The effect of this change is twofold. First, it is intended to make clear that these organizations may receive some outside income, including investment income, without losing their exempt status. Second, it is intended that the level of income a social club can derive from the use of its facilities or services by nonmembers be somewhat higher than was previously the case, without the organization losing its exempt status.

The decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based on all the facts and circumstances. However, this facts and circumstances approach is to apply only if the club earns more than is permitted under the new guidelines. If the outside income is less than the guidelines permit, then the club's exempt status will not be lost on account of nonmember income.

It is intended by this change that these organizations be permitted to receive up to 25 percent of their gross receipts, including investment income, from sources outside of their membership without losing their tax-exempt status. Within this 25-percent amount it is intended that not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. In effect, this latter modification increases the proportion of gross receipts a club may receive from making its club facilities available to the general public from 5 percent (current audit standard, Rev. Proc. 71-17) to 15 percent without losing its exempt status. This also means that a club exempt from taxation (as provided by sec. 501(c)(7) of the code) would be permitted to receive up to 25 percent of its gross receipts from a combination of investment income and receipts from nonmembers so long as the latter do not represent more than 15 percent of total receipts.

Gross receipts would be defined for this purpose as those receipts from normal and usual activities of the club (that is, those activities they have traditionally carried on) including charges, admissions,

[4] The bill continues the present law requirement that no part of the net earnings of the organization may inure to the benefit of any private shareholder.

membership fees, dues, assessments, investment income (such as dividends, rents, and similar receipts), and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income would not be included in the formula; that is, it would not be included in either the gross receipts of the club or in the permitted 25- or 15-percent amounts. However, these organizations would not be allowed to receive, within the 15- or 25-percent limitations, income from the active conduct of businesses not traditionally carried on by these organizations.

It is intended that a social club, national organization of a college fraternity or sorority, and any other organization exempt under section 501(c)(7) may receive the full 25-percent amount of its gross receipts from investment income sources (reduced by any amount of nonmember income, discussed above). This means that a national organization of a college fraternity or sorority which has no outside income from the general public's use of its facilities may receive investment income up to the full 25-percent amount of its gross receipts. On the other hand, in the case where a social club permits nonmembers to use its club facilities and receives 15 percent of its gross receipts from these nonmember sources, it may receive only up to 10 percent of its gross receipts from investment income.

*Dividends received deduction for exempt social clubs, etc.*—The second amendment made by this bill (subsection (b) of the bill) denies a corporate dividends received deduction to tax-exempt social clubs and voluntary employees beneficiary associations (described in secs. 501(c)(7) and (9)) in computing their "unrelated business taxable income." Under present law the unrelated business taxable income of these organizations is defined as their gross income (excluding any exempt function income) less the deductions under this chapter "which are directly connected with the production of the gross income" (again excluding exempt function income). The bill provides that the corporate dividends received deduction is not to be considered as a deduction which is "directly connected with the production of gross income."

*Dividends received deduction for nonexempt membership organizations.*—The third amendment made by this bill (subsection (c) of the bill) denies a corporate dividends received deduction to taxable social clubs and other membership organizations operated primarily to furnish services or goods to members (referred to in sec. 277 of the code). These organizations, with certain exceptions set forth in present law, are permitted deductions attributable to furnishing services, insurance, goods or other items of value to their members only to the extent of the income derived from members or transactions with members. The bill provides that the corporate dividends received deduction (secs. 243, 244, and 245 of the code) is not to be allowed to corporations to which this provision of law applies.

### *Prior committee action*

In the 92nd Congress, the committee reported out an identical bill (H.R. 11200) on March 16, 1972 (Report No. 92-929). In the 93rd Congress, one of the provisions included in the committee's tax reform bill of 1974 was identical to this bill.

*Effective date*

The amendment with respect to the changes in the requirement for exempt status of clubs under section 501(c)(7) is to apply retroactively to taxable years beginning after December 31, 1969, the effective date of the provision in the Tax Reform Act of 1969 extending the unrelated business income tax to social clubs, college fraternities, etc.

The amendment denying the corporate dividends received deduction to tax exempt social clubs and voluntary employees beneficiary associations applies retroactively to taxable years beginning after December 31, 1969, the effective date of the provision of the 1969 act taxing unrelated business taxable income (including investment income) of social clubs and voluntary employees beneficiary associations.

The amendment denying the corporate dividends received deduction to taxable social clubs and other membership organizations operated primarily to furnish services or goods to members applies to taxable years beginning after December 31, 1970, the effective date of the provision of the 1969 act limiting the deductions of taxable membership organizations.

*Revenue effect*

It is estimated that the revenue effect of this bill will be a small revenue gain, probably less than $100,000 a year.

*Departmental position*

The Treasury Department is not opposed to this bill. The Treasury took the same position with respect to H.R. 11200 which was reported out by the committee in the 92d Congress.

### 3. H.R. 2474—Mr. Schneebeli

### Refunds in the Case of Certain Uses of Tread Rubber and Tires

*Present law*

Present law (sec. 4071) imposes a tax of 5 cents per pound on tread rubber used for retreading tires of highway-type vehicles and a tax of 10 cents per pound on new tires used on highway vehicles.[1]

In the case of new tires a credit or refund of tax is provided where the tire is exported, is sold for use as supplies for vessels or aircraft engaged in foreign trade, or is sold for exclusive use by a State or local government or by a nonprofit educational organization (sec. 6416(b)).

*Issues*

There are several instances under present law where a manufacturers tax is imposed on tread rubber when in a similar situation a manufacturers tax would not be imposed (or a credit or refund would be allowed) on a new tire.

First, rubber wasted in manufacturing new tires is not subject to tax since the tax is imposed when the completed tire is sold and is imposed only upon the material actually in the completed tire. The tax on tread rubber is imposed before the completion of a major manufacturing process—the recapping or retreading of a used tire. Wastage of tread rubber in that process occurs after the tread rubber tax liability has been determined, and under present law no refund or credit is provided for any portion of the tax imposed on tread rubber which is wasted.

Second, under present law, where the sale of a new tire is adjusted on account of a tread mileage or road hazard guarantee or other similar arrangement, a credit is allowed for a portion of the tax in accordance with the amount of the adjustment in price. However, if the sale of a retreaded tire is adjusted under the same circumstances, no credit or refund of the tread rubber tax is provided.

Third, a credit or refund of the tax on new tires is available when the tire is exported, sold to a State or local government, sold to a nonprofit educational organization, or used or sold for use as supplies for a vessel or aircraft. A credit also is available where a new tire is mounted on a new automobile that is then disposed of in any of the above ways. However, no credit or refund is available for the tread rubber tax when a recapped or retreaded tire (or the car on which it is mounted) is disposed of in any of those ways.

In addition to these problems, the present credit or refund of tax which is permitted in cases of new tire guarantee or warranty adjustments is computed incorrectly because the amount of the refund is based on the price of the replacement tire (not the original tire) and

[1] The tax is scheduled to be eliminated for tread rubber and to be reduced to 5 cents per pound for new tires on October 1, 1977 (sec. 4071(d)).

because the refund is not available where an individual other than the original buyer receives the adjustment.

*Explanation of bill*

The bill would make a credit or refund of the tread rubber tax available in three situations. These changes are intended to permit a credit or refund of the tax on the tread rubber used on a recapped or retreaded tire, under the circumstances where a credit or refund would be available for the tax on a new tire.

First, the credit or refund is to be available where rubber is destroyed, scrapped, wasted, or rendered useless in the recapping or retreading process.

Second, the credit or refund is to be available where the tread rubber is used in the recapping or retreading of a tire if the sale's price of the tire is later adjusted because of a warranty or guaranty. Where a sale of a retreaded tire is adjusted, the overpayment (that is, the amount available for credit or refund) is to be the same proportion of the tax as the adjustment in the sales price of the retreaded tire is of the sale price (this same method of computing the overpayment is also provided in the bill for new tires, as is discussed below).

Third, a credit or refund of the tread rubber tax is to be available to the manufacturer for the tread rubber on a recapped or retreaded tire if the tire is by any person (1) exported, (2) sold to a State or local government for the exclusive use of a State or local government, (3) sold to a nonprofit educational organization for its exclusive use, or (4) used or sold for use as supplies for a vessel or aircraft.

Finally, where a retreaded tire is sold by a second manufacturer on or in connection with another article (for example, a truck) manufactured by him, the bill provides that a credit or refund of the tread rubber tax is to be allowed to the further manufacturer if the article is exported or sold for any of the above purposes. Also, a credit or refund of the tread rubber tax is to be available to the manufacturer of the recapped or retreaded tire if that retreader sells the tire on or in connection with any other article manufactured by him, and that other article is exported or sold by any person for one of the purposes described above.

In addition, the bill makes it clear that present credit or refund for any tire tax paid in cases of guarantee or warrantee adjustments is to be based on the adjusted price of the tire being returned (not the replacement tire) and is to be available whether or not any replacement tire is made by the same manufacturer as the tire being returned and whether or not a replacement tire is obtained.

*Prior committee action*

A substantially similar proposal was included in the committee's 1974 tax reform bill (sec. 554).

A substantially similar bill was reported favorably by the committee in 1972 (H.R. 5527, H. Rept. 92–785). An earlier version (dealing with tread rubber but not with adjustments on new tires) was reported favorably by the committee in 1970 (H.R. 18251, H. Rept. 91–174). The 1970 version was amended in the Senate regarding an unrelated matter (relating to drawbacks of distilled spirits taxes) and the bill died shortly afterward at the end of the 91st Congress.

*Effective date*

The amendments made by this bill are to take effect on the first day of the first calendar month which begins more than 10 days after the date of the bill's enactment.

*Revenue effect*

The bill is expected to result in a negligible revenue loss, less than $100,000 annually.

*Departmental position*

The Treasury Department favors enactment of the bill, but suggests the following three changes:

(1) The bill includes language (not in prior versions) to provide that the credit or refund, in the case of an adjustment of a new tire, is not to be less than the tax computed on the original tire at the time of adjustment times the unused service in the original tire. Treasury recommends deletion of this language, since the manufacturer may give the dealer a credit or refund for less than this amount.

(2) The bill includes language (not in prior versions) to provide a presumption that, in the case of an adjustment of the price of a new tire, the tax was paid by the ultimate consumer within two years before the adjustment. Treasury agrees that a modification of the statute of limitations is appropriate, but recommends that it relate only to payment by the manufacturer, not by the ultimate consumer.

(3) Treasury recommends adding a provision to impose a tax on tread rubber incorporated in tires which have been exported from the United States as used tires, retreaded abroad, and then reimported.

## 4. H.R. 2984—Mr. Conable

### Treatment of Payment or Reimbursement of Government Officials for Expenses of Foreign Travel by Private Foundations

*Present Law*

The Tax Reform Act of 1969 added a provision to the code (sec. 4941) which in general prohibits certain "self-dealing" acts between private foundations and certain designated classes of persons, commonly referred to as "disqualified persons" by imposing a graduated series of excise taxes on the self-dealer (and also on the foundation manager who willfully engages in acts of self-dealing). Under this provision, the payment or reimbursement of expenses of a government official by a private foundation generally is classified as an act of self-dealing.

A limited exception to this provision permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States. Under this exception, it is not an act of self-dealing for a private foundation to pay or reimburse a government official for actual transportation expenses, plus an amount of other traveling expenses not to exceed 125 percent of the maximum per diem allowed for like travel of employees of the United States for travel solely within the United States. However, no such payment is permissible for travel to or from a point outside the United States.

*Issue*

The issue is whether private foundations should be allowed to pay or reimburse government officials for expenses for foreign travel subject to the same limitations as in the case of domestic travel.

*Explanation of bill*

The bill amends present law (sec. 4941(d)(2)(G)) to provide an exception to the self-dealing provisions of the code for payment or reimbursement of a limited amount of foreign travel expenses of a government official by a private foundation. The travel expenses which are eligible to be reimbursed are for travel between a point in the United States and a point outside the United States. The amount which can be reimbursed for any one trip by a government official is (1) the lesser of (a) the actual cost of the transportation involved, or (b) $1,000 plus (2) an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under section 5702(a) of title 5, United States Code (relating to like travel by U.S. employees) for a maximum of four days. Under section 5702(a), in the case of travel outside the continental United States, the President or his designee has the authority to establish the maximum per diem allowance for the locality where the travel is performed. Currently, 125 percent of the daily amount so established for travel expenses in London is $53.75, for travel in Paris, $73.75, and for travel in Tokyo, $68.75.

*Effective date*

This provision is to apply with respect to travel beginning after the date of enactment of this bill.

*Revenue effect*

It is not expected that this bill will have any direct revenue effect.

*Department position*

The Treasury Department supports this legislation.

### 5. H.R. 3052—Messrs. Rostenkowski and Schneebeli

### Treatment of Option Lapse Income of Exempt Organizations

*Present law*

With the exception of social clubs and employees' beneficiary associations,[1] the investment income of exempt organizations generally is not subject to the tax on unrelated business income. The types of investment income sources listed as being free of this tax include dividends, interests, annuities, royalties, and capital gains from the sale of investments.

The tax treatment on income which an exempt organization receives from writing options to buy or sell securities generally depends on whether the option is exercised, lapses, or is terminated. If an option written by an exempt organization on a security is exercised and the security is required to be sold (a "call") by the exempt organization, the premium received for the option is treated as part of the gain or loss from the sale. In this case the entire gain on the sale—including the premium on the option—realized by the exempt organization is free of tax since under present law (sec. 512(b)(5)) the term "unrelated business taxable income" excludes all gains or losses from the sale, exchange, or other disposition of property (except in the case of inventory and property held for sale to customers). Similarly, if the option written on a security is exercised and the security is required to be purchased (a "put") by the exempt organization, the premium income received for the option is treated as reducing the purchase price of the security. Subsequently, if the security is sold, this reduced purchase price means a larger capital gain on the sale of the security, which as noted above is excluded from the tax base of the exempt organization (except in the case of inventory and property held for sale to customers).

On the other hand, if an option is not exercised by the exempt organization (in the case of either a put or a call) and the option lapses, the premium which the exempt organization receives generally is treated as ordinary income rather than as income from the sale of property.[2]

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[1] In this report further references to "exempt organizations" do not include these two categories (secs. 501(c) (7) and (9)).

[2] Present law (sec. 1234(a)) provides that gain or loss in the case of the sale or exchange of an option is to be given the same treatment as would the gain or loss on the sale of the property to which the option relates. However, in the case of the failure to exercise an option, this provision indicates that only in the case of a loss is the failure to be treated as having the same character as the underlying property. On the basis of this, where there is a gain on the failure to exercise an option, the regulations provide (sec. 1.1234–1(b)) that this gain represents ordinary income to the writer of the option (even though the payment of the premium by the holder of the lapsed option results in a capital loss to that holder).

Under present law (sec. 1234(c)) gain from the lapse of an option written as part of a "straddle" (a simultaneously granted combination of an option to buy and an option to sell the same quantity of a security at the same price during the same period of time) is treated as gain from the sale or exchange of a capital asset held for not more than 6 months on the date that the option expired (see regulation sec. 1–1234–2(f), example (3)). Consequently, option lapse income from "straddles" is already excluded from unrelated business taxable income of exempt organizations (other than the social clubs and employees' beneficiary associations referred to above).

As a result, the premuim received by an exempt organization on a lapsed option generally is subject to the unrelated business income tax.

In some cases, the writer of an option may "buy in" an option which he has previously written (or an option identical to one which he has previously written) and which has not yet been exercised. This offsetting transaction, known as a closing purchase, terminates his obligation under the first option. The option writer would receive a gain in the amount of the excess of the premium received for the original option over the amount paid for the second option purchased to terminate the first. As in the case of lapsed options, the gain from terminated options (which are necessarily unexercised options) is also generally ordinary income.

*Issue*

The issue is whether premiums received for options should be treated differently in the case of exempt organizations, depending on whether or not the options are exercised, lapse, or are terminated.

*Explanation of bill*

The bill amends present law (sec. 512(b)(5)) to exclude from the term "unrelated business taxable income" all gains on the lapse of options to buy or sell securities, when the options have been written in connection with the exempt organization's investment activities. Thus, the term "unrelated business taxable income" is to exclude all premiums received by an exempt organization on options which it writes under these circumstances, regardless of whether the option is exercised, lapses, or is terminated.

At the present time, the Chicago Board Options Exchange is the only U.S. exchange for trading options. However, other exchanges are considering expanding into options trading.

*Prior committee action*

In the 92nd Congress, the committee reported out a similar bill (H.R. 11196) on February 7, 1972 (Rept. No. 92–826). Also, in the 93rd Congress, one of the provisions included in the committee's tax reform bill of 1974 was similar to this bill.

*Effective date*

This amendment applies to gains from options which lapse or are terminated after January 1, 1975.

*Revenue effect*

It is estimated that this bill will have no effect, or at most a negligible effect (under $100,000) on the revenues.

*Departmental position*

In a report to the committee on May 29, 1973, the Treasury Department indicated that it had no objection to the bill.

## 6. H.R. 3055—Mr. Rostenkowski

### Distilled Spirits

The bill consists of a series of technical and administrative provisions. The following is a description of each of the sections of the bill.

(*1*) *Identification of distiller—gin and vodka*

*Present law.*—Under present law (sec. 5233(c)), no trademarks may be placed upon bottles of distilled spirits bottled in bond unless the name of the distiller or of the company in whose name the spirits are produced and warehoused also appears "conspicuously" on the bottle. This requirement extends to gin and vodka as well as to other forms of distilled spirits.

*Issue.*—Gin and vodka are produced from neutral spirits produced by grain processing plants. These neutral spirits are then purchased by the companies that process the gin and vodka itself. Since the ultimate manufacturers or processors of the gin or vodka are not the distillers or producers, they are foreclosed from placing their own names on the bottles unless the names of the grain processing plants are also placed conspicuously on the bottles. Most gin and vodka bottled in bond is exported. The issue presented by the bill is whether it is so important that the foreign customer of the gin and vodka be shown, conspicuously, the name of the grain processing plant that produced the basic neutral spirits.

*Explanation of provision.*—The bill would exclude gin and vodka bottled in bond for export from the requirement that, if the bottle is to carry a trademark, the name of the actual distiller or of the individual or company in whose name the spirits were produced and warehoused must also be on the bottle.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (see 534(a)).

*Departmental position.*—The Treasury proposes that the identification requirement be eliminated for *all* spirits exported, not just gin or vodka. In addition, the Treasury suggests that since the identification of the actual distiller is not required unless the spirits are bottled in bond, the entire identification requirement should be eliminated, whether or not the spirits are bottled in bond and whether or not for export.

(*2*) *Drawback of tax on exported spirits and wines previously imported*

*Present law.*—Under present law, a drawback equal to the amount of the tax determined or paid on wines or distilled spirits that are exported is allowed if the wines or distilled spirits were manufactured or produced in the United States. (If the tax has been determined but not yet paid, the drawback takes the form of a book credit. If the tax determined has been paid, the drawback results in a repayment of the tax.)

If the operator of a customs manufacturing bonded warehouse reduces the proof of imported distilled spirits and bottles or packages them, he may then export those spirits and obtain a drawback on the U.S. tax (sec. 5523). However, if a domestic proprietor of a distilled spirits plant imports distilled spirits and conducts the same operations and then exports them, he is not entitled to a drawback of the U.S. tax.

Similar distinctions operate in the case of wines.

*Issue.*—Whether it is appropriate to permit drawbacks of tax for exported spirits which (1) were domestically produced or (2) were first imported and then processed in a customs warehouse (as at present) but not to permit such drawbacks of tax where the exported spirits were first imported and then processed in a domestic distilled spirits plant.

*Explanation of provision.*—The bill would enable distilled spirits or wines "bottled, or packaged in casks or other bulk container" in the United States (after their import) to be exported with the benefit of drawback of the tax determined or paid on those distilled spirits or wines. The same benefit would continue to be extended to distilled spirits or wines manufacture or produced in the United States and subsequently exported. The same technical requirements regarding claims for drawback, stamps, notices, bonds, bills of lading, and other evidence indicating payment or determination of tax and exportation would be applicable to distilled spirits and wines bottled or packaged in the United States as are applicable to goods manufactured or produced in the United States.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (sec. 534(b)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision.

### *(3) Return of tax-determined distilled spirits to bonded premises*

*Present law.*—Present law (sec. 5215) allows distilled spirits (other than products to which any alcoholic ingredients other than tax-determined distilled spirits have been added) withdrawn from bond on payment or determination of tax to be returned to bonded premises for destruction, denaturing, redistilling, or (except for homogeneous spirits) mingling. For these cases, present law (sec. 5008(d)) allows the abatement, remittance, credit, or refund of the tax that has been paid or determined. All provisions of law applicable to distilled spirits in bond are also applicable to these distilled spirits returned to bond.

Present law (sec. 5612) generally prohibits the storage of tax-paid or tax-determined distilled spirits on bonded premises. Moreover, present law also specifically prohibits the return to bonded premises of tax-paid or tax-determined distilled spirits merely for storage pending exportation, or for storage pending similar dispositions.

*Issue.*—Whether tax-determined distilled spirits ought to be returnable to bonded premises in the plant where bottled or packaged for storage pending withdrawal for exportation or other purposes listed in sections 5214(a) and 7510; whether spirits that can be treated as bottled in bond although actually bottled outside of bond ought to be transferable to bonded premises for storage pending withdrawal for any purpose for which spirits actually bottled in bond may be stored; and whether these provisions should be extended to spirits brought in from Puerto Rico or the Virgin Islands.

*Explanation of provision.*—The bill would permit tax-paid (or tax-determined) distilled spirits to be returned to a storage facility in the bonded premises of the plant where they were bottled or packaged. The bill also would permit spirits treated as bottled in bond distilled spirits to be returned to the plant where bottled or packaged for storage pending withdrawal for any purpose for which spirits physically bonded in bond may be stored and withdrawn. Finally the bill would permit abatement, etc., of tax in the case of distilled spirits brought into the United States from Puerto Rico or the Virgin Islands when the distilled spirits are returned to the bottling plant, on the same basis as such abatement, etc., is allowed for distilled spirits that are domestically produced.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (sec. 534(c)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision. In general, the effect of these provisions would reduce working capital requirements of distilled spirits plant proprietors but would not affect their ultimate tax liability.

(*4*) *Withdrawal for transfer to customs bonded warehouse*

*Present law.*—Under present law (sec. 5214(a)(4)), distilled spirits may be withdrawn without payment of tax from the bonded premises of distilled spirits plants for exportation, but there is no comparable provision allowing withdrawal without payment of tax for transfer to customs bonded warehouses for storage pending exportation.

*Issue.*—Whether distilled spirits should be allowed to be withdrawn, without payment of tax, from bonded premises for transfer to customs bonded warehouses for storage pending exportation.

*Explanation of provision.*—The bill would permit distilled spirits bottled in bond (under sec. 5233) or spirits returned to bonded premises (see the explanation of section 3 of the bill, *supra*) to be transferred without payment of tax to a customs bonded warehouse for storage pending exportation. The spirits so transferred would be entered, stored, and accounted for under such regulations and bonds, to protect the revenue, as the Secretary may prescribe.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (sec. 534(d)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision.

(*5*) *Withdrawal for scientific purposes*

*Present law.*—Present law (sec. 5214(a)(9)) permits distilled spirits to be withdrawn from the bonded premises of a distilled spirits plant free of tax for use as samples in making tests or laboratory analyses.

*Issue.*—Whether, and with what safeguards, distilled spirits should be able to be withdrawn from bonded premises for use in research, development, or testing (other than consumer testing) where tax has not been paid or determined.

*Explanation of provision.*—The bill would permit distilled spirits to be withdrawn without payment of tax by a proprietor of bonded premises for use in research, development, or testing (other than consumer testing or other market analysis) of processes, systems, materials, or equipment relating to distilled spirits or distillery operations.

The withdrawals would be subject to such limitations and conditions as to quantities, use, and accountability as the Secretary may by regulations require for the protection of the revenue.

Because of the change of the nature of withdrawals under the provision from withdrawals "free of tax" to withdrawals "without payment of tax," the tax may be reimposed in the case of abuses or certain losses prior to the permitted uses for which the spirits were withdrawn.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (sec. 534(e)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision.

(6) *Mingling and blending*

*Present law.*—Under present law (sec. 5234(a)(2)) distilled spirits mingled on bonded premises must be returned to the same packages (barrels) from which removed and the mingling must be for the purpose of further storage in bond. In addition, the mingling must be made within eight years of the date of original entry for deposit of the spirits.

*Issue.*—At one time, the period within which distilled spirits could be stored in bond without tax determination and the period within which distilled spirits could be mingled both were 8 years. However, in 1958 the maximum storage period was lengthened to 20 years. The issue is whether spirits intended to be mingled and stored for more than 8 years have to be mingled within 8 years and then returned to their packages, in order to have the benefit of a delay in tax determination, or whether the maximum mingling period should be lengthened to 20 years, so as to again match the maximum storage period.

*Explanation of provision.*—The bill would lengthen the amount of time in which distilled spirits in bond may be mingled from eight to 20 years. This is in the nature of a conforming change to the present section 5006(a)(2) of the Code, which was amended in 1958 to provide that distilled spirits could be stored in bond without tax determination for 20 years.

*Previous committee action.*—This provision (other than two conforming changes) was included in section 1915(a)(17) of H.R. 10612 (Tax Reform Act of 1975). Also, the same provision was included in the committee's 1974 tax reform bill (sec. 534(f)).

*Department position.*—The Treasury Department has no objection to enactment of this provision.

(7) *Use of extracted oils of juniper berries and other aromatics in making gin*

*Present law.*—Present law (sec. 5025(b)) allows an exemption from the rectification tax (in general, this is a tax on redistilling to achieve a different product) in the case of production of gin by redistillation of a pure spirit over juniper berries and other natural aromatics.

*Issue.*—Whether extracted oils of juniper berries and other natural aromatics may be used in redistallation of gin.

*Explanation of provision.*—The bill would permit an exemption from the rectification tax in the case of gin produced by the redistallation of a pure spirit over the extracted oil of juniper berries and other natural aromatics.

*Previous committee action.*—This provision was included in the committee's 1974 tax reform bill (sec. 534(g)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision. It notes that this provision would permit production of gin with greater uniformity of product and without loss of quality.

*(8) Distilled spirits brought in from Puerto Rico or the Virgin Islands*

*Present law.*—Present law provides for abatement or refund of tax in the case of distilled spirits: (1) lost while in bond; (2) voluntarily destroyed while in bond; (3) voluntarily destroyed on bottling premises to which removed after payment or determination of tax; (4) lost (in a manner described in the law) after withdrawal from bond on payment or determination of tax and before removal from the bottling premises to which removed from bond; or (5) returned to the bonded premises of a distilled spirits plant for certain preferred purposes after payment or determination of tax.

Because of the wording of the law, bulk spirits brought into bonded premises from Puerto Rico and the Virgin Islands qualify for the abatement of tax in situation (1) just listed, but not for abatement or refund of tax in the other cases.

*Issue.*—Whether the other noted abatement-of-tax provisions should be made applicable to distilled spirits brought in from Puerto Rico or the Virgin Islands.

*Explanation of provisions.*—The bill would make the other noted abatement-of-tax provisions applicable to distilled spirits brought in from Puerto Rico or the Virgin Islands.

*Previous committee action.*—This provision was included in section 1915(a)(2) of H.R. 10612 (Tax Reform Act of 1975). This provision was also included in the committee's 1974 tax reform bill (section 534(h)).

*Departmental position.*—The Treasury Department has no objection to enactment of this provision. It notes that this provision would remove a competitive disadvantage to the bottling in this country of bulk spirits manufactured in Puerto Rico or the Virgin Islands.

*Effective date*

The amendments made by the bill are to take effect on the first day of the first calendar month which begins more than 90 days after the bill's enactment.

*Revenue effect*

It is estimated that sections 3 and 4 would result in a one-time revenue loss of $3 to $5 million because persons withdrawing distilled spirits from bonded premises for bottling or packaging and subsequent return to an export storage facility on the bonded premises, and persons withdrawing spirits from bonded premises for transfer to a customs bonded warehouse for storage pending exportation, would no longer have their payments of tax on the distilled spirits tied up until evidence of export is received and the drawback claim is allowed.

The remaining changes proposed by the bill would have little revenue effect.

## 7. H.R. 3605—Mr. Pickle

### Reduction in Beer Tax for Small Brewers

*Present law*

An excise tax at a rate of $9 per 31-gallon barrel is imposed under present law (sec. 5051) on all beer produced or imported in the United States. The tax is levied upon the brewer or importer. Beer is, in general, defined for these purposes to include ale, sake and other fermented beverages which are produced from malt and contain one-half percent or more of alcohol by volume. A brewer is defined as any person who produces beer for sale.

*Issue*

It has been pointed out that shortly after the repeal of the constitutional amendment on prohibition with respect to alcoholic beverages there were over 700 breweries operating in the United States. Since that time there has been a decline in this number until there are presently about 120 engaged in the commercial production of beer and other fermented products, despite the fact that annual U.S. beer production has increased from 38 million barrels in 1934 to 153 million barrels in 1974. It is further pointed out that the ten largest U.S. brewers supplied 80 percent of U.S. beer production in 1974. It has been suggested that one cause for the decline in the small regional breweries is the difficulty small brewers have in competing with the large national breweries.

The issue is whether a reduction in the Federal excise tax on beer is appropriate to enable small brewers to compete more effectively with the large national concerns.

*Explanation of bill*

Under the bill, the excise tax on beer would be reduced for qualified brewers to $7 per barrel on the first 60,000 barrels sold for consumption or sale during each calendar year. A qualified brewer is one which produces no more than 2 million barrels for the calendar year. Where the controlling interest in one brewing corporation is held by another or where the same person owns the controlling interests in two such corporations, the production of these related brewers is considered as the production of one brewer for purposes of these provisions. The tax saving under this amendment would be limited to no more than $120,000 for each qualified brewery or qualified group of related breweries.

*Prior committee action*

In the 93rd Congress, one of the provisions included in the committee's tax reform bill of 1974 was similar to this bill.

*Effective date*

This bill is effective for the first calendar year which begins after the enactment of the bill.

*Revenue effect*

It is estimated the bill will result in a revenue loss of approximately $5 million per year.

*Departmental position*

The Treasury Department is opposed to this bill. The Treasury does not believe it is desirable to use the excise tax system to alter the competitive position of firms within an industry. The Treasury expressed concern that if the approach in the bill were adopted it would establish a precedent to control competition in other areas which could represent a significant source of interference in the flexibility needed to achieve an efficient reallocation of resources as technology changes. Furthermore, the Treasury does not believe that the tax savings (a maximum of $120,000 per year per brewer) is large enough to have any real impact on the viability of small brewers.

## 8. H.R. 5071—Mr. Conable

### Maintenance of Common Trust Fund by Affiliated Banks

*Present law*

Under existing law a bank may maintain a "common trust fund" which fund itself is neither subject to Federal income taxation nor considered a corporation. A fund qualifies as a common trust fund if it is (1) maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed by the bank in its fiduciary capacity, and (2) maintained in conformity with rules and regulations of the Comptroller of the Currency pertaining to the collective investment of trusts. The income (including gains and losses from the sale of property) from the fund, representing amounts contributed from various separate trusts, is included in the gross income of each participant in the common fund on the basis of its proportionate share of the income.

The purpose of the common trust fund provision is to permit diversification in the investment of trust funds for which a bank has fiduciary responsibility.

The Internal Revenue Service has taken the position (Rev. Rul. 70-302) that a fund maintained by a member bank of a bank holding company will not qualify as a "common trust fund" if it accepts contributions to the fund by other member banks (or trust companies) acting in a fiduciary capacity. The Internal Revenue Service holds that under present law the common trust fund must be "maintained" by the bank which contributes the moneys to the fund for investment. The staff also understands that the Internal Revenue Service holds that a fund maintained by various members of a bank holding company will not qualify even if each member bank acts as a cotrustee of the common fund.

*Issue*

As discussed above, under present law there is a difference in the tax treatment accorded a common fund by banks which are related through stockholdership with a common parent and a common fund where only one bank is involved (because the State where it is located permits branch banking). The issue is whether there is any substantive reason for a difference in tax treatment in these cases and whether a pooling of the trust funds for investment purposes should be permitted.

*Explanation of bill*

The bill amends the provision dealing with common trust funds (sec. 584) to provide that when banks are members of the same affiliated group (within the meaning of sec. 1504) they are, for purposes of this provision, to be treated as one bank for the period of their affiliation. Consequently, if banks are affiliated (as defined in sec. 1504) they may maintain a common trust fund to which they can contribute funds held in their capacity as trustee, executor, administrator or guardian.

It is not necessary under the bill that banks contributing money to the fund act as cotrustees of the common trust fund. The affiliated group of banks may maintain a common trust fund if any member of the group serves as trustee. (Of course, one or more members of the affiliated group may serve as cotrustees, but this is not required.)

*Prior committee action*

This bill is substantially the same as H.R. 7025, 92nd Congress, which was reported favorably by the committee in 1972 (House Report 92–702). Also, in the 93rd Congress, one of the provisions included in the committee's tax reform bill of 1974 was identical to this bill.

*Effective date*

The bill would apply to taxable years beginning after December 31, 1974.

*Revenue effect*

This bill is estimated to have a negligible revenue effect.

*Departmental position*

The Treasury Department supports this bill. The Comptroller of the Currency has previously indicated that he has no objection to the bill and will encounter no additional difficulty in regulating and administrating common trust funds maintained by affiliated banks.

## 9. H.R. 5161—Mr. Corman

### Tax Treatment of Magazines Used for Display Purposes

*Present law*

Generally, taxpayers using the accrual method of accounting for income must include sales in income for the taxable year when all the events have occurred which fix the right to receive the income and the amount can be determined with reasonable accuracy. Generally, the method used by the taxpayer in determining when income is to be accounted for is acceptable by the Internal Revenue Service if it accords with generally accepted accounting principles consistently used by the taxpayer from year to year. As an example, the income tax regulations (Regs. § 1.446–1(c)(1)) provide that a taxpayer engaged in a manufacturing business may account for sales of the product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping books. When sales of products are returned to a taxpayer during a taxable year the return is generally treated as a reduction from gross sales for purposes of financial and tax accounting.

Tax accounting differs from financial accounting in that tax accounting does not permit deductions for estimates of future costs. Thus, tax accounting does not permit an offset in the year in which the sale is made for the return of magazines in the following year.

*Issue*

Magazine publishers and distributors often distribute to retail outlets more copies of a magazine than it is anticipated the retailer can sell. The extra copies are distributed to assure the retailers an adequate number of copies for display purposes. When the next issue of the magazine is published and shipped to the retailer, the earlier issue is treated as being "off-sale" and the retailer returns the unsold copies of the magazine to the publisher.

Many publishers have for a number of years accounted for their returns of magazines on a net basis (by calculating the estimated returns) at the time of shipment. The Internal Revenue Service has taken the position that accrual basis publishers and distributors must include the sales of the magazine in income when the magazines are shipped to the retailers and may only exclude from income returns of the magazines when the copies are returned by the retailer during the taxable year. The argument is made that when the sale and the return of the magazine occurs in two separate taxable years, this method tends to create a distortion of income for Federal tax purposes.

The issue is whether, when magazines are shipped to retailers for display purposes with no expectation on the part of the parties that these magazines will be sold, it is appropriate to treat the shipments as income to the publisher or distributor.

*Explanation of bill*

The bill provides an election for accrual method taxpayers in the case of sales of magazines or other periodicals for display purposes. Under this provision, a taxpayer may elect not to include in gross income for the taxable year in which the magazines or other periodicals are shipped the income attributable to the sale of any magazine or other periodical which is returned not later than the fifteenth day of the third month after the close of the taxpayer's taxable year (i.e., the date on which the corporate tax return is generally due). In addition to the physical return of the magazine to the publisher the taxpayer may establish under procedures which are to be provided by regulations that the periodical has not been sold and will not be sold. For example, it is customary sometimes not to return the entire magazine but merely to cut off the front cover and return that portion of the magazine.[1]

A sale is for display purposes under this provision if the sale is made in order to permit an adequate display of the magazine or other periodical and if at the time of sale the taxpayer has a legal obligation to accept returns of the magazine or other periodical.

These provisions apply to sales for display purposes if and only if the taxpayer makes an election under this provision with respect to the trade or business in connection with which the sales are made. An election under this provision may be made only with respect to taxable years beginning after December 31, 1974, and only with the consent of the Secretary or his delegate. The election is to be made in the time or manner as the Secretary may by regulations prescribe.

An election of this provision applies to all sales of magazines and other periodicals made for display purposes in connection with the trade or business with respect to which taxpayer has made the election. However, the election does not apply to sales made for display purposes before the first taxable year for which the election is made. Once an election is made, it is effective for the taxable year with respect to which it is made and for all subsequent taxable years unless the taxpayer secures the consent of the Secretary or his delegate to the revocation of the election. The computation of taxable income under an election under this provision is treated as a method of accounting. Thus, the provisions of the code relating to adjustments required by changes in method of accounting (sec. 481) apply to the making and the revocation of the election.

The amendments provided by this bill have been requested by the Peterson Publishing Company; however, the bill has a general application to the entire magazine publishing industry.

*Prior committee action*

In the 93rd Congress, the committee included an identical provision in its tax reform bill of 1974.

*Effective date*

The bill is to apply to taxable years beginning after December 31, 1974.

[1] In cases where the magazine is not returned it is sometimes the practice to contribute the magazine to a charitable organization. In cases where the magazine is contributed rather than sold to a charitable organization, documentation of this fact would be an acceptable method of substantiating that the magazine has not been and will not be sold. In these cases, however, charitable contribution deductions are not to be allowed.

*Revenue effect*

It is estimated that this provision will result in a decrease of $10 million in tax liabilities in the first year that it is effective.

*Departmental position*

The Treasury Department does not oppose this legislation. However, it recommends that the treatment provided by the bill be made available only where the taxpayer customarily refunds a substantial amount of his sales (perhaps as much as 20 or 30 percent of total newsstand distribution of an issue). Also, Treasury recommends that the effective date be changed to taxable years beginning after December 31, 1975, to avoid having to create special rules for making the required accounting method change. In general, requests for changes in accounting method must be filed within the first 180 days of the taxable year for which the change is requested, and for many taxpayers that period will have expired for the year beginning in 1975.

## 10. H.R. 6521—Mr. Duncan

### Exemption From Tax on Farm Trailers and Horse Trailers

*Present law*

Section 4061(a)(1) of the code imposes a 10-percent tax on the sale by the manufacturer, producer, or importer of enumerated articles including truck trailer and semitrailer bodies and chassis.[1] Section 4061(a)(2) provides an exclusion from the tax, however, for sales of bodies and chassis of "light-duty" trucks, buses, and truck trailers and semitrailers.[2] To qualify for the exemption, the truck trailer and semitrailer chassis and bodies must be suitable for use with a trailer or semitrailer having a "gross vehicle weight"[3] of 10,000 pounds or less (determined according to Treasury regulations). In addition, the truck trailer or semitrailer itself must be suitable for use with a towing vehicle with a gross vehicle weight of 10,000 pounds or less.

Section 4061(b) imposes an 8-percent manufacturers excise tax on parts and accessories for the vehicles, etc., that are subject to the 10-percent tax, but exempts any part or accessory which is suitable for use (and ordinarily is used) on a passenger automobile, automobile trailer or semitrailer, or house trailer.

*Issue*

Present law exempts "light-duty" trailers and semitrailers suitable for use with "light-duty" trucks. The issue is whether the light-duty limitation on the trailer or semitrailer should be removed in the case of trailers or semitrailers designed to be used for farming purposes or for transporting horses or livestock.

Present law does not exempt parts and accessories for light-duty trucks, etc.; it does exempt parts and accessories which are suitable for use (and ordinarily are used) for passenger automobiles. The issue is whether parts and accessories for trailers or semitrailers designed to be used for farming purposes or for transporting horses or livestock should be exempted from the manufacturers tax.

*Explanation of bill*

The bill would provide an exemption from the manufacturers excise tax in the case of trailers, semitrailers, and bodies and chassis for trailers or semitrailers that are suitable for use with a towing vehicle with a gross vehicle weight of 10,000 pounds or less. To qualify for the exemption, however, the trailer or semitrailer must be designed for use for farming purposes or for transporting horses or livestock. In

[1] The tax rate is to be reduced to five percent for sales on or after October 1, 1977.

[2] Sales of automobiles and automobile trailers and semitrailers were exempted by the Revenue Act of 1971. Since many families, particularly farm families, use light trucks as automobiles, sales of certain light trucks and their trailers and semitrailers were also exempted from the tax.

[3] "Gross vehicle weight" means the maximum total weight of a loaded vehicle. Temporary Regs. § 142.1-1(d)(3).

addition, parts or accessories suitable for use with an exempt trailer, semitrailer, or trailer or semitrailer body or chassis are also to be exempt.

To avoid creating competitive disadvantages because of the relative size of dealers' inventories, and in conformity with prior practice, the bill would provide for floor stocks refunds with respect to all articles exempted by the bill that are still in dealers' inventories on the day after the bill's enactment.

*Effective date*

The exemptions proposed by the bill would apply with respect to articles sold on or after the date of enactment.

*Revenue effect*

The revenue loss from this provision is expected to be less than $5 million annually.

*Departmental position*

The Treasury Department has indicated objections to enactment of this bill, because of discrimination against single-unit trucks (i.e., without trailers or semitrailers) and nonfarm trailers and semitrailers; also there is concern about the treatment of parts and accessories, since existing provisions require them to be "primarily designed" or "ordinarily used" for the specified exempt purposes.

### 11. H.R. 7228—Mr. Duncan

## Devices Other Than Stamps on Distilled Spirits Containers as Evidence of Tax Payment

*Present law*

Under present law, evidence of the payment of the Federal excise tax on distilled spirits is required to be demonstrated by attaching to the container what is commonly known as a "strip stamp." This is a paper stamp that is attached to the container in such a manner that it will be broken (thereby voiding it) on opening the container. Present law restricts the preparation and distribution of the strip stamps to the Secretary of the Treasury or his delegate. The stamps are now made by the Bureau of Engraving and Printing.

*Issue*

Recent developments in the technology of bottle container closures indicate that it may become simpler and less costly in the future to use devices other than paper stamps as evidence of payment of the excise tax on distilled spirits. For example, the evidence of this tax payment may be printed on a metallic strip used to form the closure of a bottle; this strip also will be broken and thereby voided when the bottle is opened.

If the Treasury Department were to permit the use of means or devices other than a paper stamp as evidence of the tax payment, it is pointed out that there may be a problem in providing the other means or devices. The paper stamps now are provided by the Bureau of Printing and Engraving which is geared to printing on paper. The Federal Government is not now equipped to process other materials.

The issue is whether the Treasury Department should be permitted to authorize the use of means other than stamps as evidence of tax payment, and if so, should persons outside the government be authorized to prepare and distribute other forms or devices for evidence of tax payment under whatever controls are necessary to protect Federal revenues.

*Explanation of the bill*

The bill amends present law to allow the Treasury Department to authorize the use of other forms or devices as evidence of payment of the excise tax on distilled spirits than paper stamps. The bill further allows the Secretary of the Treasury to authorize the preparation and distribution by persons outside of the Federal Government of stamps and other forms of evidence of tax payment. In addition, the Secretary is to prescribe whatever controls are necessary for the protection of the Federal revenues involved when persons outside of the Federal Government are authorized to prepare and distribute stamps or other devices for evidence of excise tax payment.

It is expected that the Treasury Department will authorize experimental projects with a view to determining their efficiency and ability to protect the revenue if persons outside the Government are authorized to prepare and distribute evidence of tax payment for attachment to distilled spirits containers.[1]

The staff understands that ALCOA has indicated an interest in having this change of procedures implemented.

*Prior committee action*

This proposal initially was recommended by the administration on July 13, 1972; H.R. 16022 (identical to this bill) was reported unanimously by the committee (Rept. No. 92–1522) but not acted on by the House. In the 93rd Congress, one of the provisions included in the committee's tax reform bill of 1974 was identical to this bill.

*Effective date*

The amendments made by this bill would become effective upon the date of enactment.

*Revenue effect*

The staff estimates that this bill will have no effect on Federal revenues.

*Departmental position*

The Treasury Department has filed a report on November 3, 1975, favorable to this bill. In 1972 and 1973, the Treasury Department sent identical bills to the Congress asking for their consideration and enactment.

The Justice Department has filed a report favorable to this bill.

[1] This statement was contained in the committee's report (Rept. No. 92–1522) of H.R. 16022 in the 92nd Congress which was identical to this bill.

## 12. H.R. 8046—Mr. Duncan

### Exclusion From Income of Rental Value of Parsonage Furnished to Surviving Spouse of Minister

*Present Law*

Under present law (sec. 107 of the code), a minister of the gospel is entitled to exclude from his gross income the rental value of a home furnished to him as part of his compensation or the allowance paid to him for housing.

This provision applies to anyone who is an ordained, licensed, or commissioned minister of the gospel and performs such services as normally considered functions of such a person. The exclusion does not apply to the surviving spouse of a deceased minister.

*Issue*

Under present law, if the surviving spouse of a deceased minister continues to receive the same housing benefits which were provided tax-free to the minister during the performance of his ministerial duties, then these amounts are included in the gross income of the surviving spouse. However, the housing benefits furnished a minister of the gospel during his lifetime were a part of his compensation and if furnished to his surviving spouse after his death could be considered to be furnished because of the prior services rendered by the minister.

The issue is whether the exclusion from income of the rental value of a home furnished to a minister should be continued for the surviving spouse of the minister.

*Explanation of bill*

The bill provides, generally, that if the widow or widower of a deceased minister of the gospel continues to be furnished a home or continues to receive a rental allowance after the death of the minister and if the allowance was excludable by the minister under present law (sec. 107), then the widow or widower may likewise exclude from gross income this amount. The exclusion by the widow or widower, however, is not to apply with respect to periods after the date of remarriage.

*Effective date*

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

*Revenue effect*

It is estimated that enactment of this bill will result in a decrease in tax liability of approximately $5 million a year.

*Departmental position*

The Treasury Department opposes enactment of this bill. It sees no justification for extending the section 107 exclusion, which has itself been the subject of criticism. While the existing exclusion may possibly be justified on the ground that a parsonage is provided for the convenience of the church as part of a minister's employment (and that the exclusion of housing allowances provides an equivalent for ministers who do not receive a parsonage), this rationale would clearly not be applicable to the surviving spouse of a deceased minister.

## 13. H.R. 8125—Mr. Burke

### Revision of Tax Structure on Large Cigars From Bracket System to an Ad Valorem Tax

*Present law*

Under present law, the manufacturers excise tax on large cigars (those weighing more than 3 pounds per thousand cigars) is imposed on the basis of a bracket system with the rate of tax dependent on the retail price of the cigar. The brackets are as follows:

| Intended retail price per cigar (in cents) | | Tax per thousand |
|---|---|---|
| Over— | Not over— | |
| 0 | 2½ | $2.50 |
| 2½ | 4 | 3.00 |
| 4 | 6 | 4.00 |
| 6 | 8 | 7.00 |
| 8 | 15 | 10.00 |
| 15 | 20 | 20.00 |
| 20 | | 20.00 |

The retail price of a cigar is defined for Federal tax purposes as "the ordinary retail price of a single cigar in its principal market."

*Issue*

It has been pointed out that the present bracket system is arbitrary in that it produces widely varying effective rates of tax depending on the retail price of the cigar. The effective rate of tax depends on a combination of the rate of tax for the given bracket and the point within the bracket that a cigar is intended to sell for. Thus, in the wide bracket covering cigars intended to retail for over 8 cents and not over 15 cents, the tax of $10 per thousand varies from a maximum of 12 percent of the intended retail price (including the tax) for cigars priced at three for 25 cents to a minimum of 6.7 percent for cigars intended to retail for 15 cents each. This 6.7-percent minimum effective rate also applies to cigars at the top of the over 4 cents and not over 6 cents bracket. However, in the over 6 cents and not over 8 cents bracket, the minimum effective rate is 8.8 percent. At the bottom of the tax scale (namely, in the case of cigars intended to retail for not more than 2½ cents each) the tax of $2.50 per thousand imposes an effective rate of 10 percent of the retail price for cigars intended to retail at two for 5 cents.

The issue is whether the tax on large cigars should be revised from a bracket system to an ad valorem tax.

A secondary issue is whether the tax should be based on the intended wholesale price or on the intended retail price as under present law.

*Explanation of the bill*

The bill replaces the present tax on large cigars (those weighing more than 3 pounds per thousand [1] with a flat ad valorem tax of 8½

[1] Small cigars are not taxed on the basis of price. Their tax rate is 75 cents per 1,000.

percent of the wholesale price. In addition, the bill defines wholesale price as the manufacturer's or importer's suggested price at which cigars are to be sold to retailers. Generally this wholesale price is the traditional manufacturer's or importer's declared intended catalog or list delivered bulk price to retailers.

*Prior committee action*

In the 92nd Congress, H.R. 3544 was favorably reported by the committee (Rept. No. 92–660) which is the same as this bill, except that it also gradually decreased the tax (from 8½ percent to 6½ percent). In the 93rd Congress, one of the provisions in the tax reform bill of 1974 was identical to this bill.

*Effective date*

The new tax rate system is to go into effect on the first day of the first month which begins more than 90 days after the date of enactment of the provision.

*Revenue effect*

This bill is estimated to reduce revenue $11 million a year. (This is slightly higher than the previous estimates ($9 million a year) because the pattern of cigar consumption has changed.)

*Departmental position*

The Treasury Department has indicated that it supports the bill.

## 14. H.R. 8283—Mr. Corman

### Types of Flavors Permitted To Be Used in the Production of Special Natural Wines

*Present law*

Under present law, for purposes of the code provision relating to cellar treatment and classification of wines (secs. 5381–5388), special natural wines may be made with the addition (before, during or after fermentation) of "natural" flavorings and natural herbs, spices, fruit juices, aromatics, or essences. Flavors other than natural are not permitted to be used in producing special natural wines.

Section 5386(a) thus now refers to the permitted addition to wines of "natural herbs, spices, fruit juices, aromatics, essences, and other natural flavorings in such quantities or proportions as to enable such products to be distinguished from any natural wine not so treated * * *."

*Issue*

The processing of natural flavors—including percolation, distillation and extraction—often destroys some of their desired end-product flavor. The desired flavor can be restored, however, by adding small amounts of flavor other than natural to the wine. As indicated, however, such additions are not permitted under present law.

The issue is whether flavors other than natural should be permitted to be used in the production of special natural wines.

*Explanation of bill*

The bill amends present law (sec. 5386(a)) to permit flavors other than natural to be used in producing special natural wines. This change means that the addition of flavors other than natural to "special natural wines" would have to be approved in advance by the Secretary of the Treasury or his delegate before they could be used in the making of such wines.[1]

*Effective date*

The bill is effective upon the date of enactment.

*Revenue effect*

It is estimated that the enactment of the bill would have no effect on tax revenues, and, further, that the additional costs to be incurred by the Government under the proposed change would be negligible.

*Departmental position*

The Treasury Department has filed a report dated October 8, 1975, with respect to this bill and has indicated that it has no objection to the enactment of the bill.

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[1] The bill would appear to have a technical defect. Present law allows the addition of natural flavorings without the approval of the Secretary or his delegate. The bill as introduced would require natural flavorings as well as the other flavorings (which would be newly permitted to be added in the production of the wine) to be approved by the Secretary or his delegate. It would appear that it is intended not to change present law but to only require the "other flavorings" which are added by the bill to be approved by the Secretary or his delegate.

## 15. H.R. 9889—Mr. Burke

## Extension of Time To Amend Governing Instruments of Certain Charitable Remainder Trusts

*Present law*

The Tax Reform Act of 1969 imposed new requirements which must be satisfied by a charitable remainder trust in order for an estate tax deduction to be allowed for the transfer of a remainder interest to charity. Under these new requirements, no estate tax deduction is allowable for a remainder interest in property (other than a remainder interest in a farm or personal residence) passing at the time of a decedent's death in trust unless the trust is in the form of a charitable remainder annuity trust or unitrust or pooled income fund. These rules generally apply in the case of decedents dying after December 31, 1969. However, certain exceptions were provided in the case of wills executed or property irrevocably transferred in trust on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills until October 9, 1972 (unless the will was modified in the meantime) to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969, (which did not come within the statutory exceptions) to qualify for an income, estate or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the governing instrument had to be amended was further extended by the Internal Revenue Service.[1] On August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72–395 which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under section 664.

In 1974, Congress extended the date by which the governing instrument of a trust created after July 31, 1969, and before September 21, 1974, or pursuant to a will executed before September 21, 1974, could be amended (P.L. 93–483). Under this Act, if the governing instrument is amended to conform by December 31, 1975, to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund, an estate tax deduction will be allowed for the charitable interest which passed in trust from the decedent even though the interest failed to qualify at the time of the decedent's death.

[1] T.I.R. 1060 (December 13, 1970) extended the date to June 30, 1971; T.I.R. 1085 (June 11, 1971), extended the date to December 31, 1971; T.I.R. 1120 (December 17, 1971); extended the date to June 30, 1972; and T.I.R. 1182 (June 29, 1972), extended the date to the 90th day after final regulations were issued.

Where a judicial proceeding is required to amend the governing instrument, the judicial proceeding must begin before December 31, 1975, and the governing instrument must be amended to conform to these requirements by the 30th day after the judgment becomes final.

In any case where the governing instrument is amended after the due date for filing the estate tax return, the deduction will be allowed upon the filing of a timely claim for credit or refund (sec. 6511) of an overpayment. However, no interest will be allowed for the period prior to the end of 180 days after the claim for credit or refund is filed.

*Issue*

The issue is whether there should be further extensions of the date for amending the governing instrument of a charitable remainder trust in order to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund and thereby qualify for the estate tax deduction.

*Explanation of bill*

The bill extends the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, and before September 21, 1974, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction.[2] Under the bill, if the governing instrument is amended by December 31, 1977, to conform to the requirements of a charitable remainder annuity or unitrust or pooled income fund, an estate tax deduction will be allowed for the charitable interest which passed in trust from the decedent even though a deduction was not allowed for this interest because the trust failed to qualify as a charitable remainder trust at the time of the decedent's death.

*Effective date*

This amendment applies with respect to decedents dying after December 31, 1969.

*Revenue effect*

It is estimated that this provision will decrease estate tax liability by less than $5 million during the 2-year period 1976–1977.

*Departmental position*

The Treasury Department believes that transitional rules must come to an end sometime and notes that 6 years have passed since the enactment of the charitable remainder trust rules. However, it would not object to a one year extension if it is made clear that further extensions will not be granted.

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[2] The bill also extends the date in the case of a trust created after July 31, 1969, pursuant to a will executed before September 21, 1974.

## 16. H.R. 10051—Mr. Waggonner

### Treatment of Returned Inadvertent Distributions of Life Insurance Companies

*Present law*

Under present law, the taxable income of a stock life insurance company for a taxable year consists of three elements referred to as phase I, phase II, and phase III (sec. 802). Phase I consists of the lesser of the taxable investment income [1] of the life insurance company for that year or its gain from operations for that year; phase II consists of one-half of the excess, if any, of the company's gain from operations over its taxable investment income for that year; and phase III generally consists of the portion of the other half of such excess which is treated as distributed to shareholders of the company for the year. Thus, a life insurance company's taxable investment income for a particular year and one-half of its underwriting income (the excess of its gains from operations over its taxable investment income) are taxed on a current basis. The portion of its underwriting income which is not taxed currently is generally taxed as phase III income when it is treated as distributed to shareholders.

Under the code, a life insurance company credits the tax-deferred half of its underwriting gains to a policyholders surplus account.[2] Amounts may be subtracted from the policyholders surplus account, credited to the shareholders surplus account, and distributed to shareholders (sec. 815). Under these rules, however, amounts subtracted from the policyholders surplus account for a taxable year are includable in the life insurance company's taxable income for that year.

This three-phase system of taxation generally permits deferral of tax on a portion of a life insurance company's underwriting gains until it becomes clear that the company itself has made a determination that these amounts constitute income which was not required to be retained to fulfill policyholders contracts.[3] The deferral is allowed because it is difficult to establish with certainty the actual annual income of a life insurance company. Due to the long-term nature of life insurance contracts, amounts which may appear as income in the current year, and as proper additions to surplus, may as a result of subsequent events be needed to fulfill life insurance contracts.[4]

In order to determine the amount of phase III income for a particular taxable year, the amount actually distributed from the policyholders surplus account is "grossed-up". The gross-up is necessary to equate the insurance company with an ordinary corporation. For ex-

[1] Generally, the taxable investment income of a life insurance company is the life insurance company's share of the yield on its investments, reduced by investment expenses, depreciation, depletion, certain real estate expenses and trade or business expenses. The policyholder's share of investment yield is not taxed to the company.

[2] Section 815 provides limitations on the amount which may be credited to the policyholder's surplus account.

[3] Sen. Rept. 291, 86th Cong., 1st Sess., p. 25.

[4] Sen. Rept. 291, 86th Cong., 1st Sess., p. 20.

ample, in order to distribute a $10,000 dividend to its shareholders in after-tax dollars, an ordinary corporation with income in excess of the surtax exemption ($25,000) would have to earn $19,231 and would pay a tax of $9,231 on that income. Under the gross-up rule, if a stock life insurance company's taxable income exceeds the surtax exemption, a $10,000 distribution from the policyholders surplus account would result in phase III income of $19,231 [5] for the year. Thus, $19,231 would be subtracted from the policyholders surplus account with respect to the distribution, the life insurance company would pay tax of $9,231 with respect to the distribution, and $10,000 would be credited to the shareholders surplus account and distributed to the shareholders.

*Issue*

The life insurance company tax rules provide a priority system for determining whether a distribution to shareholders is derived from the shareholders surplus account, the policyholders surplus, or other accounts. Under this system, distributions to shareholders are considered to be made from the policyholders surplus account only after the balance of the shareholders surplus account has been reduced to zero. Thus, if a life insurance company makes a distribution to shareholders in excess of the balance of its shareholders surplus account, the excess is considered to be from the policyholders surplus account (limited to the balance of that account).

It has been pointed out that the phase III tax may be nearly half of the gross amount or may exceed 90 percent of the amount actually distributed from the policyholders surplus account and that such a tax may be irrevocably triggered by a distribution which results from an inadvertent error in making complex computations.

The Internal Revenue Service has interpreted present law to require a life insurance company to pay the phase III tax on a wholly unintentional distribution out of the policyholders surplus account even though the shareholders of the company promptly return the distribution upon learning of the error, and even though the company has a long-standing policy of limiting its distributions to stockholders to amounts in the shareholders surplus account and footnoting its published financial statements with a statement that the company has "no present plans for distributing the amounts in policyholders surplus". Under this interpretation, amounts distributed out of the policyholders surplus account by mistake are held subject to the phase III tax even though they were restored to the company before its return for the year was due.

The issue is whether distributions of life insurance companies which were inadvertently made and are attributable to the policyholders surplus account but which are subsequently returned to the company should be allowed to be treated as if they were not made and thereby deferred from tax (as would be the case if they had not been made).

*Explanation of bill*

The bill prevents the imposition of the phase III tax on amounts inadvertently distributed by a life insurance company from the policy-

[5] $\$10,000 \div \frac{100}{(100-48)} = \$19,231.$

holders surplus account. It provides that no amount is to be subtracted from an insurance company's policyholder surplus account with respect to a distribution made during the last month of the company's taxable year (which distribution would otherwise be treated as the distribution out of the policyholders surplus account) to the extent the amounts so distributed are returned to the company no later than the time prescribed by law (including extensions thereof) for filing the company's return for the taxable year in which the distribution was made.

Under the bill, the amounts so returned are to be applied first to restore the amounts which would otherwise be treated as distributed out of the policyholders surplus account.

The relief provided by the bill would not be available if at the time the distribution was made by the company it intended to avail itself of the provisions of the bill by having its shareholders return all or a part of the distribution.

The distribution is to be taxed to the shareholder under the usual rules. Under the bill, the basis to a shareholder of his stock in the company is not to be increased by reason of amounts returned under these rules to the extent that a dividends received deduction or exclusion is allowable with respect to the distribution.

This bill has been requested by Business Men's Assurance Company of America (BMA) with respect to a distribution made in December 1969. The amount of money involved in the inadvertent BMA distribution was nearly \$5.5 million. In this case the principal shareholder of the company [6] promptly returned the distribution upon learning of the error.

*Effective date*

The amendment made by the bill would apply with respect to taxable years ending after December 31, 1957 (the effective date of the Life Insurance Company Tax Act of 1959, which established the three-phase system of taxing life insurance companies).

*Revenue effect*

Other than the revenue loss involved with respect to BMA (approximately \$5 million), the bill is not expected to have any significant effect on the revenues in the future.

*Departmental position*

The Treasury Department has indicated that it is not opposed to this bill. The Treasury indicated that since the corrections must be made prior to the due date for the filing of the return for a year, the administrative problems caused by the bill and its retroactivity should be minimal.

[6] The principle shareholder (99.8 percent) of the Business Men's Assurance Company of America is BMA Corporation of Kansas City, Missouri, a publicly held corporation.

## 17. H.R. 10101—Mr. Pickle

### Exemption From Fuel and Use Excise Taxes for Certain Aircraft Museums

*Present law*

Under present law (secs. 4041 and 4081) gasoline and special fuels used in noncommercial aviation, including use by aircraft museums, are subject to manufacturers and retailers excise taxes totalling 7 cents per gallon of gasoline or special fuel. Exemptions from the gasoline and special fuels taxes are presently provided where the aircraft is used by commercial airlines, for farming or as supplies for vessels or aircraft engaged in foreign trade, a State or local government, or a nonprofit educational organization.[1] In those cases where the manufacturers excise taxes have been paid, a mechanism is provided for refunds of these taxes if the gasoline or special fuel is consumed by an exempt user.

There is also imposed an annual excise tax upon the use of civil aircraft. This tax (under sec. 4491) is based largely upon the weight of the aircraft.[2]

*Issue*

There are several "flying aircraft museums" which presently operate in the United States. These maintain and operate vintage airplanes either at fixed locations or at displays and airshows in various parts of the country. The aircraft are flown a limited number of times each year. The flying aircraft museums are generally funded largely by membership dues and outside contributions.

It is pointed out a considerable part of the expense of maintaining and operating these aircraft museums consists of Federal fuel excise taxes and aircraft use taxes, despite the fact that these types of aircraft make only limited, or no use, of aircraft aids, such as radar and instrument landing systems, provided by the Federal Government and funded through the fuel and aircraft use taxes. The issue is whether these flying aircraft museums should be exempt from the fuel and use excise taxes.

*Explanation of bill*

This bill exempts aircraft museums (of the type specified below) from the retailers and manufacturers excise taxes which apply to gasoline and special fuels used by noncommercial aviation. A mechanism is also provided for refunds or credits of manufacturers excise taxes where they have already been paid on gasoline used by an aircraft museum. In addition, aircraft operated by an aircraft museum are exempted from the use tax on civil aircraft. An aircraft museum is defined, for these purposes, as an organization described in Code sec-

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[1] An educational organization for these purposes is, in general, one which maintains a faculty and curriculum to conduct on-site educational activities.

[2] The annual tax rate is $25 plus 2 cents per pound of takeoff weight over 2,500 pounds in the case of a nonturbine powered aircraft, and 3½ cents per pound in the case of a turbine powered aircraft.

tion 501(c)(7) [3] which is exempt from Federal income taxes under section 501(a), which operates as a museum under a State charter to acquire and exhibit aircraft used in World War II.

This bill is intended to cover the Confederate Air Force Flying Museum in Texas as well as several other similar organizations in the United States.

*Effective date*

The amendments pertaining to exemptions from and refunds of the gasoline and special fuels taxes would become effective on January 1, 1976. The exemption from the aircraft use tax would take effect on July 1, 1976.

*Revenue effect*

It is estimated that these amendments will result in a revenue loss of approximately $50,000 per year.

*Departmental position*

The Treasury Department has indicated that it is opposed to this bill. The Treasury indicates that although the argument presented in support of the bill is that the planes of the museum do not use the expensive electronic facilities of the airway system, cost allocation studies of the Department of Transportation indicate that noncommercial aviation is greatly undertaxed. In the case of the annual use tax, the Treasury indicates that although the tax may be burdensome on an organization that uses its planes only a few times a year, the tax is actually a charge for the availability of facilities, and that a similar situation with the highway use tax exists in the trucking industry for seasonal operators and those who drive a limited number of miles each year.

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[3] The reference in the amendment to a § 501(c)(7) organization appears to be in error, since at least one of the aircraft museums to which this amendment is apparently designed to apply, is an educational organization for which an income tax exemption was granted under § 501(c)(3).

## 18. H.R. 10155—Mr. Vander Veen

### Tax Treatment of Certain Income of Political Organizations

*Present Law*

Under present law (sec. 527 of the code) political organizations (such as political parties or committees) are generally subject to Federal income taxation on income from investments and income from any trade or business. However, the exempt function income of such organizations is not taxable.

Under present law, "exempt function income" includes contributions of money or other property and membership fees, dues, or assessments from members of the organization. Exempt function income also includes proceeds received from political fund-raising or political entertainment events, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business. Thus, proceeds received from casual sporadic fund-raising events or political entertainment events, such as political dinners, receptions, or an annual athletic exhibition, are to be treated as exempt function income. However, in all of these cases the income is exempt function income only if the event is a political event and is not carried on in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business, for purposes of this section, include the frequency of the event, the manner in which the event is conducted, and the span of time over which the event is carried on. Whether an event is a political fundraiser or a political entertainment event will depend upon the facts and circumstances of the particular event, taking into account the extent to which the event is related to a political activity aside from the need of the organization for income or funds.

In addition, amounts received on the sale of campaign materials are eligible for exempt function income treatment under present law if the sale is not in the ordinary course of a trade or business, and is substantially related to the political activities of the organization. Thus, proceeds from the sale by a political organization of political items such as political memorabilia, bumper stickers, campaign buttons, hats, shirts, political posters, stationery, jewelry, or cookbooks are generally not to be taxable to the political organization where the sale is closely related to other political activity such as distributing political literature, organizing voters, etc. However, where these materials are sold in the regular course of a trade or business, the income derived from the sale is to be taxable.

*Issue*

The issue is whether net receipts derived from a trade or business in which substantially all the work in carrying out the trade or business is performed for a political organization without compensation should be exempt from tax.

*Explanation of bill*

The bill provides that income received by a political organization from any trade or business which is regularly carried on would not be taxable if substantially all the work in carrying on the trade or business is performed for the political organization without compensation. Thus, the bill provides that a political organization would not ordinarily be taxed on income from political fund-raising or entertainment events, or from the sale of political campaign materials, even if the events or sales are regularly carried on, if substantially all the work performed in connection with the events and sales is normally performed by unpaid volunteers. This would have the effect of treating political organizations in a manner similar to tax exemption organizations (under sec. 501), since these other organizations are not generally subject to the tax on income with respect to any trade or business regularly carried on "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation" (sec. 513(a)(1)).

It is understood that the bill is designed to exclude from political organization taxable income, income raised through the operation of bingo games which, under some State laws, may be used for political fund raising purposes and which are operated by volunteers.

*Effective date*

The bill applies to taxable years beginning after December 31, 1974.

*Revenue effect*

It is estimated that the bill will have a negligible effect on revenues, a loss of less than $100,000 annually.

*Departmental position*

The Treasury Department has indicated that it does not oppose this bill. The Treasury did indicate, however, that the committee should include in its report a statement that the trade or business referred to is bingo or a similar fund-raising operation and not all commercial activities.

## 19. H.R. 10902—Mr. Green

## Tax Treatment of Securities Acquired for Business Reasons and Not as an Investment

*Present law*

Under present law, the treatment of gain or loss on a sale or exchange of a stock or other security depends on whether the security is a capital asset in the hands of the taxpayer. Any stock or other security which is held for investment is treated as a capital asset and if held for more than 6 months is accorded the more favorable long-term capital gain treatment (that is, only one-half of the gain is subject to tax). Capital losses, however, are limited for both individuals and corporations as to the amount that may be deducted in a year. If a stock or other security is held for business purposes, generally it would not be treated as a capital asset and, therefore, any gain would be treated as ordinary income and any losses would be treated as ordinary losses (which could be deducted in full in the current year). As a result, if a taxpayer has a gain on the sale of a stock or other security, he would prefer to have capital gain treatment. However, if there is a loss from the sale, he would prefer to have ordinary loss treatment.

The question of whether a security (or any asset) is a capital asset is factual and depends on the facts and circumstances of the particular case, i.e., whether the taxpayer acquired and held the security as an investment or whether he acquired and held it for sale to customers in the ordinary course of business or held the stock for use in his business. In some situations, individuals or corporations which have acquired stock in another company and later sold such stock at a loss have successfully argued that they purchased and held the stock to assure themselves a source of supply of the other company's products or for similar business reasons. As a result these taxpayers have often been upheld in treating their loss as ordinary rather than capital. Few, if any, situations have arisen, however, where in similar circumstances a gain on later sale of the stock or securities has been held to be ordinary income.

Under present law (sec. 165(g)(1)) a loss resulting from a security becoming worthless during the taxable year is a capital loss if the security is a capital asset. The loss is ordinary if the security is not a capital asset in the taxpayer's hands. A special statutory rule also provides ordinary loss treatment for a security held by a parent corporation in a controlled subsidiary where the security becomes worthless during the taxable year (sec. 165(g)(3)).

*Issue*

The question raised by the case law to date is whether, under present law, a taxpayer can too readily obtain the best of both worlds when he sells or exchanges a stock or other security by contending that he did not hold the stock as an investment (if he wants ordinary loss treatment) or that he did hold it as an investment (if he wants capital gain treatment).

*Explanation of bill*

The bill adds a new provision (sec. 1254) which requires a taxpayer (including individuals and corporations) to notify the Secretary within 30 days after initially acquiring a security that the acquisition was not made as an investment in order to obtain ordinary loss treatment on a sale or exchange of the "security" (as defined in present sec. 165 (g)(2)). The bill authorizes the Service to issue regulations concerning how the notice must be given and the information it must contain. The giving of notice would not guarantee ordinary loss tratment for a taxpayer; he would still have to establish that he did not acquire and hold the stock as a capital asset. The bill simply adds a threshold conditions for ordinary loss treatment that, in any event, the taxpayer must have filed the required notice within the required period.

If a taxpayer filed the necessary notice and realizes a gain when he sells the security, the bill provides that his gain shall be ordinary income and not capital gain. In such a situation, ordinary income treatment is automatic; the bill does not permit the taxpayer to show that on the particular facts he held the stock as a capital asset.

These rules operate together to prevent a taxpayer from subsequently coloring his description of his original purposes in acquiring a security, depending on whether he suffers a loss or realizes a gain on sale of the security.

The bill also adds a notice requirement in order for a worthless security to be treated as producing an ordinary loss. Where a security becomes worthless during the year, the taxpayer may obtain an ordinary loss only if he establishes that the security was not a capital asset in his hands and also that, within 30 days after he initially acquired the security, he notified the Service that he held the security other than as an investment.

This notice requirement would not be imposed, however, in the case of a worthless security in an affiliated corporation (under the provisions of present section 165(g)(3)).

The new section would also not apply to a securities dealer. (Sec. 1236 of present law creates uniform treatment for securities dealers by providing capital gain or loss treatment on sale or exchange if, within 30 days after he acquires a security, the dealer clearly identifies it in his records as held for investment and also if he does not later hold the security for sale to customers. A dealer who does not identify his securities in this manner receives ordinary income or loss when he sells the security.)

*Effective date*

The bill applies to taxable years ending after the date of enactment. However, the new rules would not apply to any sale or exchange occurring before the issuance of regulations under the new code provision.

The bill also contains a transition rule for securities acquired on or before the date of enactment of the provision, or acquired after that date but before the issuance of the first regulations under the new section. In such cases, the taxpayer's notice must be given to the Service within 30 days after such regulations have been issued (rather than within 30 days after he initially acquired the security).

*Revenue effect*

It is estimated that enactment of this provision will not have a significant revenue effect during the first two years. However, in the later years this provision could generate substantial revenue gains.

*Departmental position*

The Treasury Department opposes enactment of this bill. It notes that the bill would not entirely eliminate the problem that arises under present law of a taxpayer claiming capital gains treatment, although he would have claimed an ordinary loss if he had incurred a loss. That is, a taxpayer may forget he filed the required notice or may hope to escape detection upon audit. In addition, the requirement of a notice would introduce some additional complexity and would tend to catch taxpayers who are ignorant of the rule. Because taxpayers other than brokers and banks rarely hold securities other than in an investment capacity, they are likely to be unaware of the notice requirement. Treasury suggests that the Committee consider whether ordinary income and loss treatment on the sale of securities should be eliminated in all cases. If the provision is approved, it should be amended to exclude securities held by a bank to which section 582(c) applies.

## 20. H.R. 10926—Mr. Karth

### Treatment of Face-Amount Certificates

*Present law*

In general, present law (sec. 1232) provides that the amount of discount that arises where a corporation issues a bond, debenture, note, certificate or other evidence of indebtedness for a price less than the face amount payable at maturity is treated as ordinary income. The Tax Reform Act of 1969 amended this provision to provide that the discount attributable to a bond, note, certificate or other evidence of indebtedness issued by a corporation after May 27, 1969, is to be included in the holder's income on a ratable basis over the term of the obligation.

In 1971, the Internal Revenue Service issued regulations under section 1232 interpreting the changes made by the Tax Reform Act of 1969. These regulations provided that certain deposit arrangements with financial institutions made on or after January 1, 1971, which arrangements provide that interest will be deferred until maturity (i.e., certain certificates of deposit, time deposits, bonus plans, etc. issues by banks and similar financial institutions) are subject to the ratable inclusion rules under section 1232. Under these regulations, the application of section 1232 to face-amount certificates (as defined in section 2(a)(15) of the Investment Company Act of 1940) was reserved.[1]

Subsequently, on October 9, 1973, the Internal Revenue Service proposed further regulations which provided that a face-amount certificate issued by a corporation after March 31, 1974, would be subject to the ratable inclusion rules under section 1232. These regulations were issued in final form on March 29, 1974, applicable to face-amount certificates issued after December 31, 1974. The application of these regulations was subsequently postponed by the Internal Revenue Service on two separate occasions in order to provide Congress an opportunity to clarify its views as to the appropriate tax treatment in these cases. Pursuant to the latest postponement, a face-amount certificate issued by a corporation after December 31, 1975, is subject to the ratable rules under section 1232. Thus, under these regulations the amount of any original issued discount attributable to a face-amount certificate issued after December 31, 1975, must be included in the gross income of the holder on a pro rata basis over the term of the certificate. The amount that must be ratably included in gross income is the difference between the amount paid by the purchaser and the amount received

[1] Under section 2(a)(15) of the Investment Company Act of 1940, a "face-amount certificate means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the "installment type"): or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate).

by him at maturity. Further a corporation issuing a face-amount certificate after December 31, 1975, must amortize the discount over the life of the certificate.

On November 26, 1975, Investors Syndicate of America (I.S.A.), a corporation that issues face-amount certificates, filed an action for a declaratory judgment that these regulations, relating to face-amount certificates be declared invalid. This suit is currently pending in the United States District Court for the District of Columbia.

*Issue*

The issue is whether original issue discount attributable to a face-amount certificate should be included in the gross income of the holder ratably over the term of the certificate or included at the time of actual receipt (usually at the maturity of the certificate).

*Explanation of provision*

The bill amends present law (sec. 1232(d)) to provide that face-amount certificates are not subject to the rules under section 1232, but rather are to be taxed under section 72. As a result, the amount of discount attributable to a face-amount certificate would not to be ratably included in the gross income of the holder over the term of the certificate. Instead, the amount of discount would be included in the gross income of the holder upon actual receipt by him either at maturity or upon a premature cancellation. If the holder exercises an option to take annual payments from the corporation in lieu of a lump sum at maturity, the payments will be taxed like annuities are presently taxed under section 72, i.e., a portion of each payment received would be included in gross income and the portion attributable to the consideration furnished would be excluded.

The corporation issuing the certificate would be entitled to an interest deduction in each taxable year equal to the amount of discount accruing within that taxable year.

The provisions apply to a face-amount certificate as defined in section 2(a)(15) of the Investment Company Act of 1940. The staff understands that there are 5 companies registered with the Securities and Exchange Commission to sell face-amount certificates. One of these companies, Investors Syndicate of America (I.S.A.) a wholly-owned subsidiary of Investors Diversified Services (I.D.S.) accounts for approximately 95 percent of all sales of face-amount certificates.

*Prior committee action*

In the 93rd Congress, one of the provisions included in the Tax Reform bill of 1974 was similar to this bill.

*Effective date*

The amendment would apply to face-amount certificates issued after December 31, 1975.

*Revenue effect*

It is estimated that enactment of this provision will reduce tax liability by less than $100,000 in 1976, $150,000 in 1977, and about $500,000 in 1979.

*Department position*

The Treasury Department has no objection to this provision.

## 21. H.R. 10936—Mr. Gibbons

## Recapture as Ordinary Income of Property for Which a Business Expense Deduction Was Allowed

*Present law*

Under present law (sec. 1245), gain realized upon the sale or exchange (or certain other dispositions) of section 1245 property (generally tangible personal property and certain other property subject to an allowance for depreciation or amortization) is subject to recapture as ordinary income (rather than as capital gain) to the extent of any depreciation or amortization allowed with respect to that property after December 31, 1961 (or, in certain cases, later effective dates). Also, in the case of the contribution of property to charity, the deduction otherwise allowable with respect to that contribution is to be reduced by the amount of ordinary income which would have been realized by the taxpayer had the property been sold for its fair market value (sec. 170(e)). This has the effect of disallowing the deductions for any amounts which are subject to recapture under section 1245.

*Issue*

There is no provision under present law which provides that where the cost of property is deducted, instead of being depreciated or amortized, the amount deducted is to be subject to recapture as ordinary income if the property is later sold or otherwise disposed of at a gain. The issue is whether the cost of property which is deducted should be subject to recapture on the same basis as the portion of the cost of property which is depreciated or amortized.

*Explanation of bill*

Under the bill, in the case of property acquired after December 31, 1961, if the purchase price of the property was deducted as an expense (and the deduction was not disallowed), the purchase price is to be subject to recapture under section 1245. Thus, for example, if the taxpayer purchases a professional periodical which has a useful life of less than one year, and deducts the purchase price as a trade or business expense, any gain (up to the amount of the deduction) realized on the later sale of the property would be treated as ordinary income. Also, if the property were contributed to a charitable or educational institution, a charitable deduction would be allowed only to the extent that the fair market value of the property exceeds the amount of the trade or business deduction claimed previously.

*Effective date*

This provision would apply to property acquired after December 31, 1961, and disposed of after the date of enactment of this bill.

*Revenue effect*

It is estimated that the enactment of this bill will result in an increase in tax liability of less than $5 million a year.

*Departmental position*

The Treasury Department supports this bill.

## 22. H.R. 11006—Mr. Jones

### Postponement of Time for Paying Excise Tax in the Case of Fishing Equipment

*Present law*

Excise taxes presently are imposed upon manufacturers, producers and importers with respect to their sales of fishing equipment and related accessories. (sec. 4161(a)) The Internal Revenue Code (sec. 6302) provides the Treasury Department with the discretion to promulgate regulations as to the time that these taxes must be paid. The regulations (Reg. § 48.6302(c)-1) provide that if the liability for all taxes reported (on form 720) exceeds $2,000 for any month in the preceding calendar quarter, the manufacturer is required to pay such taxes on a semimonthly basis within nine days after the close of the period involved.

*Issue*

It has been pointed out that the fishing equipment industry typically is highly seasonal in terms of when the manufacturers receive payments from their vendees. However, in order to make its manufacturing and shipping operations more efficient, it is understood that industry typically produces and ships merchandise on a relatively even basis throughout the year. It has been stated that this great disparity between production and shipping schedules, on the one hand, and receipt of payment from the vendee, on the other hand, appears at present to be largely confined to fishing equipment manufacturers. It is contended that it represents a financial hardship to require these manufacturers to pay the excise taxes with respect to particular sales several months before the time payment is received on such sales.

The issue is whether the payment of excise taxes imposed upon the sale of fishing equipment and related accessories should be postponed until the receipt of payment from the vendee, but no later than eight months after the date of the sale of these items.

*Explanation of bill*

The bill amends the tax law (sec. 4161) to provide that the excise tax upon the sale of fishing equipment and related accessories will become payable upon receipt of payment from the vendee, but no later than the close of the eighth month after the date of the sale.

*Effective date*

The amendment would apply to sales occurring on or after July 1, 1975.

*Revenue effect*

It is estimated that enactment of this provision will reduce collections by $7 million during the year after enactment.

*Departmental position*

The Treasury Department opposes this provision. Vendors extend credit for varying periods determined by their own business needs and customer relations. The time for collection of Federal taxes should not depend on such vendor decisions. Moreover, vendors must finance their inventory costs as well as taxes, and it is not apparent why prompt payment of taxes imposes any greater burden than prompt payment of the cost of supplies.