

INCOME TAX TREATMENT OF CERTAIN DISCHARGES OF INDEBTEDNESS OF RAILROAD CORPORATIONS

MAY 24, 1960.—Ordered to be printed

MR. BYRD of Virginia, from the Committee on Finance, submitted
the following

R E P O R T

[To accompany H.R. 11405]

The Committee on Finance, to whom was referred the bill (H.R. 11405) to provide for the treatment of income from discharge of indebtedness of a railroad corporation in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act commenced before January 1, 1960, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY OF BILL

H.R. 11405 makes two changes in existing law. Both of these changes relate to the continuation of provisions which previously have been in effect.

First, present law provides that the discharge of indebtedness of a railroad corporation in a taxable year beginning before January 1, 1958, is not to result in taxable income for the railroad if the discharge occurred as the result of a court order in a receivership proceeding, or in a proceeding under section 77 of the Bankruptcy Act. The bill continues the application of this provision to discharges after December 31, 1959, but only if the court proceeding involved commenced before January 1, 1960.

Second, Congress in the Technical Amendments Act of 1958 provided that a deduction for accrued vacation pay is not to be denied for any taxable year ending before January 1, 1961, solely because the liability for it to a specific person has not been fixed or because the liability for it to each individual cannot be computed with reasonable accuracy. However, for the corporation to obtain the deduction the employee must have performed the qualifying service necessary under a plan or policy which provides for vacations with pay to

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qualified employees. The bill extends this same treatment to deductions for taxable years ending before January 1, 1963.

The Treasury Department has indicated that it does not object to either of the provisions in the bill.

II. GENERAL EXPLANATION OF BILL

A. DISCHARGE OF INDEBTEDNESS IN THE CASE OF RAILROADS

Section 108(a) of present law provides in general that the discharge of indebtedness by a corporation (or an individual in connection with property used in his trade or business) is not to result in an addition to gross income. However, this treatment is available only if the taxpayer agrees to reduce the basis of his property by an amount equal to the amount of indebtedness discharged. This provision was first added by the Revenue Act of 1939 although at that time this treatment was available only for taxpayers who were in an unsound financial condition. This limitation, however, was removed in the Revenue Act of 1942. When this provision was initially enacted it was intended primarily as a means of aiding hard-pressed railroads in buying up their obligations which were selling below face value. This provision was needed to prevent the realization of income at the time these securities were repurchased because the Supreme Court had held (in *Kirby Lumber Company v. U.S.* (284 U.S. 1), 1931) that a corporation realized income by purchasing and redeeming its bonds at a price less than that for which sold. This had prevented corporations from liquidating their indebtedness in order to place their affairs on a sound financial basis.

What is now section 108(b) of present law, with which the first section of this bill is directly concerned, was added in the Revenue Act of 1942. This subsection also provides that no amount is to be included in gross income as a result of the discharge of indebtedness, but in this case only in the case of a railroad corporation. Moreover, this provision is also more limited than subsection (a) in that the qualifying discharge of indebtedness can result only from an order of a court in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act. However, the railroads qualifying under this provision need not decrease the basis of their assets by the amount of the indebtedness discharged, as must be done in the case of corporations coming under the general provision.

The Corporate reorganization provisions (sec. 374) already provide for the nonrecognition of gain or loss in the case of property of a railroad corporation transferred to another railroad corporation as a result of a court order in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act. Since under this corporate reorganization provision no gain is recognized to the railroads where there is a transfer of property from one railroad corporate entity to another (in bankruptcy or receivership proceedings) it seemed appropriate to provide for nonrecognition of gain or loss (and no adjustment to basis of assets) where for other than tax reasons it was not desirable, or perhaps it was impossible, to transfer the assets to a second corporate entity. This accounts for the enactment of what is now section 108(b) in the Revenue Act of 1942. The provision in that act was effective only for discharges of indebtedness occurring

after December 31, 1939, and before January 1, 1946. In subsequent legislation the application of this provision has been extended to taxable years beginning before January 1, 1958. These extensions occurred because in all of the railroad receivership and bankruptcy proceedings, begun as a result of the depression in the 1930's, had not been completed before 1946.

A few of these railroad receivership proceedings are still in process. Therefore, the House Ways and Means Committee amended section 108(b) to provide that if the discharge of indebtedness (whether by cancellation or modification or otherwise) in the case of a railroad corporation arose as a result of a court order in a receivership proceedings or in a proceeding under section 77 of the Bankruptcy Act, then no amount is to be included in gross income with respect to it so long as the court proceeding involved commenced before January 1, 1960. This will be true in the cases where the court action began before January 1, 1960, without regard to how long after that date the discharge of indebtedness actually occurs. This should make it unnecessary to reconsider the effective date of this provision in the future in order to cover cases which are already in process.

Except for the reference described above, relating to the commencement of the court proceeding before January 1, 1960, no substantive change is made by this bill in section 108(b) other than the deletion of the sentence limiting the application of the subsection to discharges occurring in taxable years beginning before January 1, 1958.

The bill provides that this amendment is to apply to taxable years beginning after December 31, 1959, but only with respect to discharges occurring after that date.

B. DEDUCTIBILITY OF ACCRUED VACATION PAY

Under the 1939 Code (sec. 43) the period for taking deductions was stated to be the taxable year in which the expenses were "paid or accrued" or "paid or incurred," depending upon the method of accounting, "unless in order to clearly reflect the income, the deductions or credits should be taken as of a different period." In this connection, published rulings (GCM 25261, C.B. 1947-2, 44; I.T. 3956, C.B. 1949-1, 78), in general held that vacation pay for the next year could be accrued as of the close of the taxable year in which the qualifying services were rendered if under the employment contract all of the events necessary to fix the liability of the taxpayer for the vacation pay had occurred by the close of the taxable year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred, the fact that the employees' rights to a vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ended before the scheduled vacation period was not regarded as making the liability a contingent one, rather than a fixed one. It was held that the liability was not contingent since the employer could expect the employees as a group to receive the vacation pay and, therefore, that only the ultimate amount of the liability to the group remained uncertain at the close of the year.

In Revenue Ruling 54-608 (C.B. 1954-2, 8) the Internal Revenue Service reconsidered its previous rulings on vacation pay. This ruling held that no accrual of vacation pay could occur until the fact of

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liability with respect to specific employees was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. This ruling was initially made applicable to taxable years ending on or after June 30, 1955. It was then thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rules set forth in this ruling would utilize section 462 of the 1954 Code. This section of the code, however, was repealed and the Treasury Department in a series of actions continued to postpone the effective date of Revenue Ruling 54-608 until January 1, 1959 (the last postponement was made in Rev. Rul. 57-325, C.B. 1957-2, 302, July 8, 1957). It stated that Revenue Ruling 54-608 was to be inapplicable to taxable years ending before January 1, 1959, except in cases involving an agreement with a labor union which was in effect on June 30, 1957, and which expired after December 31, 1958. In such cases Revenue Ruling 54-608 was to be applicable for the first time to taxable years ending on or after the 90th day after the date such agreement expires.

Congress in the Technical Amendments Act of 1958 concluded that more time was required for study before Revenue Ruling 54-608 was made applicable to those taxpayers who were properly accruing vacation pay under I.T. 3956. Therefore, the period in which Revenue Ruling 54-608 is to be inapplicable was extended for 2 more years, or it was provided that deductions for accrued vacation pay were not to be denied for any taxable year ending before January 1, 1961, solely by reason of the fact that the liability for the vacation pay to a specific person has not been clearly established or that the amount of the liability to each individual is not capable of computation with reasonable accuracy.

Still further time is required for study before Revenue Ruling 54-608 is made fully applicable. Therefore, section 2 of this bill amends the section of the Technical Amendments Act of 1958, dealing with this matter (sec. 97) to provide a further 2-year postponement of the period of time before Revenue Ruling 54-608 is to be applicable. It provides that this ruling with respect to deductions for accrued vacation pay is not to be effective for any taxable year beginning before January 1, 1963, instead of before January 1, 1961.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italic; existing law in which no change is proposed is shown in roman):

SECTION 108 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

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(b) RAILROAD CORPORATIONS.—No amount shall be included in gross income by reason of the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation, as defined in section 77(m) of the Bankruptcy Act (11 U.S.C. 205(m)), if such discharge, cancellation, or modification

is effected pursuant to an order of a [court in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act.] court—

(A) *in a receivership proceeding, or*

(B) *in a proceeding under section 77 of the Bankruptcy Act commenced before January 1, 1960.* In such cases, the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed to a deduction. Subsection (a) of this section shall not apply with respect to any discharge of indebtedness to which this subsection applies. [This subsection shall not apply to any discharge occurring in a taxable year beginning after December 31, 1957.]

SECTION 97 OF THE TECHNICAL AMENDMENTS ACT OF 1958

(26 U.S.C., sec. 162 note; 72 Stat. 1672)

SEC. 97. DEDUCTIBILITY OF ACCRUED VACATION PAY.

Deduction under section 162 of the Internal Revenue Code of 1954 for accrued vacation pay, computed in accordance with the method of accounting consistently followed by the taxpayer in arriving at such deduction, shall not be denied for any taxable year ending before January 1, [1961] 1963, solely by reason of the fact that (1) the liability for the vacation pay to a specific person has not been clearly established, or (2) the amount of the liability to each individual is not capable of computation with reasonable accuracy, if at the time of the accrual the employee in respect of whom the vacation pay is accrued has performed the qualifying service necessary under a plan or policy (communicated to the employee before the beginning of the vacation year) which provides for vacations with pay to qualified employees.

