Calendar No. 1679

86TH CONGRESS 2d Session | SENATE | REPORT No. 1616

TRUST AND PARTNERSHIP INCOME TAX REVISION ACT OF 1960

REPORT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

TO ACCOMPANY

H.R. 9662

A BILL TO MAKE TECHNICAL REVISIONS IN THE INCOME TAX PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 RELATING TO ESTATES, TRUSTS, PARTNERS, AND PARTNERSHIPS, AND FOR OTHER PURPOSES

JUNE 18, 1960.—Ordered to be printed

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

REPORT

[To accompany H.R. 9662]

The Committee on Finance, to whom was referred the bill (H.R. 9662) to make technical revisions in the income tax provisions of the Internal Revenue Code of 1954 relating to estates, trusts, partners, and partnerships, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

I. GENERAL STATEMENT

This bill is concerned with the revision of two subchapters of chapter 1 of the Internal Revenue Code. These are subchapter J, which deals with the income tax treatment of estates, trusts, and beneficiaries, and subchapter K, which deals with the income tax treatment of partners and partnerships. The changes made in the estate and trust tax provisions appear in title I of this bill and those made in the partner and partnership provisions in title II.

The work on these subchapters began with advisory groups which were established by the Committee on Ways and Means in November 1956. The reports of these advisory groups were the subject of public hearings by the House Committee on Ways and Means in February and March of 1959 and the bill, as passed by the House, was the subject of hearings by your committee in April of this year.

A. ESTATES AND TRUSTS

The House bill, and your committee's bill, while retaining the basic structure of present law, makes a number of important substantive and technical amendments to the income tax provisions relating to estates, trusts, and beneficiaries. The amendments are concerned with prevention of tax avoidance, correction of inequities, elimination of unintended hardships and unintended benefits and the clarification of existing law.

1. Principal provisions of House bill

(1) One of the important provisions designed to prevent tax avoidance is the amendment relating to multiple trusts. Where separate trusts, created by the same grantor, accumulate income over a number of years for the same beneficiary, the splitting of the income among several taxable entities results in taxation at lower rates and reduces the overall tax burden. To prevent tax avoidance by the use of such multiple trusts the House bill, in general, taxed distributions from multiple trusts to the beneficiaries at the time they are received, to the extent that income has been accumulated in the preceding 10 years.

(2) The House bill also added provision designed to prevent income from escaping taxation in the case of the sale, etc., of property subject to legal life estates or other terminable legal interests. This is accomplished by deeming a trust to exist with respect to the gross income derived from property subject to a terminable legal interest which is not taxable to the holder of the interest.

(3) Another important change relates to the tier system which establishes an order of priority for purposes of determining which distributions to beneficiaries from estates and trusts are deemed to consist of income. The House bill establishes a three-tier system under which all beneficiaries who can receive distributions only out of income are placed in the first tier, those who can receive distributions of either income or corpus are placed in the second tier, and those who can receive distributions only of corpus are placed in the third tier.

(4) Still another important change relates to the treatment accorded charitable contributions of trusts under existing law. The bill, in the interest of simplification of the law, treats these contributions as distribution deductions, rather than as deductions from gross income as is provided by the present law. However, to eliminate opportunities for tax avoidance, such deductions are taken into account only to the extent that the distributable net income is not used up by distributions to taxable beneficiaries falling within the three tiers described above.

(5) The House bill revised the rules of present law excluding from taxation distributions of gifts and bequests of specific sums of money or of specific property, and, with respect to estates, adds a new provision which excludes distributions of real property or tangible personal property (other than money) paid from corpus of the estate within 36 months. The bill also extends the application of the separate share rule (now applicable only to trusts) to estates.

2. Principal provisions of your committee's bill

(1) Among the more important provisions designed to prevent tax avoidance is the amendment relating to multiple trusts. Your committee concurs in the need for multiple trust legislation but has adopted a different approach to the problem from that in the House bill. In lieu of imposing a tax on the beneficiary at the time of

distribution, your committee's bill imposes a tax at the trust level currently. Under the bill, if a grantor establishes two or more separate inter vivos or testamentary trusts in which the primary beneficiary or beneficiaries of the currently accumulated income or taxable income allocated to corpus are substantially the same, then such income of the separate trusts will be combined and taxed as if there were only one trust.

(2) Another important provision added by your committee is designed to prevent avoidance of U.S. tax by the establishment of foreign trusts. There was no comparable provision in the House bill. Under the bill, if a U.S. citizen or resident establishes a foreign trust, distributions received by U.S. beneficiaries from such trusts will be subject to the operation of the 5-year-throwback rule, without the benefit of the exceptions to that rule, to the extent that such distributions consist of income from sources without the United States or capital gains from the sale or exchange of capital assets which are not subject to tax under section 871.

(3) The House bill added a provision designed to prevent income from escaping taxation in the case of the sale, etc., of property subject to legal life estates or other terminable legal interests. Your committee has deleted this provision from the bill in view of recent court decisions which have eliminated the necessity for such a provision.

(4) Another important change relates to the tier system which establishes an order of priority for purposes of determining which distributions to beneficiaries from estates and trusts are deemed to consist of income. Your committee's bill retains the basic House provisions revising the tier system but makes some clarifying changes.

(5) With respect to charitable distributions the House bill, in the interest of simplification of the law, treated such payments as distribution deductions, rather than as deductions from gross income as provided under present law. In addition, the House bill, in effect, placed the charitable distributions in a fourth tier so that deductions for such amounts were taken into account only to the extent that the distributable net income was not used up by distributions to taxable beneficiaries falling within the first three tiers. Your committee has modified the House provisions by placing distributions to charitable beneficiaries in the third tier along with noncharitable beneficiaries who can receive distributions only out of corpus, and thus limiting the fourth tier to amounts which are permanently set aside or to be used for charitable purposes.

(6) The House bill also revised the rules of present law excluding from taxation distributions of gifts and bequests of specific sums of money or of specific property, and extended the application of the separate share rule (now applicable only to trusts) to estates. Your committee's bill largely retains the provisions of the House bill but modifies them to expand the exclusionary provisions to apply to distributions of certain closely held stock and distributions of amounts representing statutory awards or allowances for the support of a surviving spouse or dependents. In addition, your committee has added a new provision which did not appear in the House bill which applies to estates of decedents where the value of the gross estate is $100,000 or less. The bill, as amended, would exclude from taxation any dis-

tributions paid from the corpus of such estates within 36 months following the death of a decedent.

These and other changes made in the estate and trust provisions are described under heading II below.

B. PARTNERS AND PARTNERSHIPS

Both the House and your committee's bill retain the basic structure of the present partnership provisions. Therefore, the changes in the partnership provisions made by this bill are largely in the nature of modifications and perfections of the existing provisions. The changes in some cases take the form of removing unintended benefits, in other cases of removing unintended hardships, and in still others of clarifying the intent of existing law.

1. Principal House provisions

Your committee has retained most of the partnership provisions contained in the House bill. The principal House partnership provisions which are retained by your committee are described immediately below. These are followed by a brief summary of the principal modifications made by your committee.

To reduce the complexity of the partnership provisions in operation, especially in the case of smaller, simpler partnerships, the House bill makes two changes which were accepted by your committee. The first of these is a rearrangement of the partnership provisions. Under the rearrangement the provisions of general application, which the smaller, simpler partnership is likely to have to use, are placed first in the law, making it unnecessary in most cases for the members of these partnerships to familiarize themselves with the more technical provisions which follow. In addition, the bill provides a simplified reporting procedure which can, at the election of the partnership, be followed in those cases where most of the partnership's income (other than capital gains and losses and dividends) is ordinary income.

Among the more important unintended hardships of the existing partnership provisions corrected by the House bill and in large part accepted by your committee is the amendment relating to the time of the closing of the partnership taxable year with respect to a partner who dies. Under present law this year continues to the normal ending of the partnership year with the result that the deceased partner's successor may lose an opportunity to offset against this partnership income certain expenses incurred by the partner in his last year, as well as lose the benefits of income splitting. The bill provides that the partnership year is to close for a deceased partner at the time of his death, although permitting his successor to elect to continue the year if he so desires.

The House and your committee's versions of the bill also substitute for the present definitions of "unrealized receivables" and "inventory items", which under present law may result in ordinary income, a definition which determines whether an asset is an ordinary income asset by ascribing to it the same character it would have if the asset were held directly by an individual. In connection with the revision of these ordinary income or collapsible partnership provisions, the two versions of the bill also remove an unintended benefit under present law wherein ordinary income treatment possibly may be avoided by borrowing funds and investing them in the partnership in a manner which reduces the ordinary income assets below a specified percentage of the total.

Among other more important changes made by the House bill in the partnership provisions and accepted by your committee are those—

(1) providing in the code for the imposition of tax in certain cases where services are exchanged for an interest in the capital of a partnership,

(2) refining the rules which apply in the case of amounts paid by a partnership to a retiring partner or to a deceased partner's successor in interest,

(3) clarifying the rules applicable to income in respect of a decedent,

(4) making more precise the rules applicable in the case of transfers between related persons where one or more of the persons is a partner or partnership.

(5) providing separate elections for special bases for partnership property in the case of distributions and transfers, and

(6) permitting an election at the organization level, rather than at the level of the individual members, as to whether to make the partnership provisions inapplicable in the case of groups set up exclusively for investment or production, etc., but not for sale of property.

The changes made in the partnership provisions are described in heading III below.

2. Your committee's amendments

The principal modifications made by your committee in the House provisions relating to partners and partnerships are as follows:

(1) In section 702(e), which relates to the election for simplified reporting for partners, your committee has modified the House provision to permit this election to be made or revoked for any partnership year at any time before the end of 3 years following the due date for the partnership return.

(2) Your committee has deleted the House provision contained in section 703(b), relating to the writing off of organizational expenses of a partnership over a 5-year period.

(3) Your committee in section 741 has added a new subsection which in general provides that where partners buy the partnership interest of another partner on a pro rata basis this is to be treated in the same manner as liquidating distributions to which section 776 applies in the case of retiring or deceased partners.

(4) In section 751, relating to the definition of substantially appreciated section 751 assets (i.e., assets resulting in ordinary income tax treatment) for purposes of collapsible partnerships, your committee has made the following modifications:

(*a*) It has provided that the fair market value of section 751 assets to be "substantially appreciated" must exceed 125 percent of their cost or other basis and must exceed 15 percent of the value of all other partnership property (with certain exceptions). This is in lieu of the present tests of 120 percent and 10 percent, respectively.

(*b*) It has provided that assets are to be considered as "substantially appreciated" only if the gain involved amounts to more than $1,000, taking into account other comparable gains occurring in the 12-month periods immediately before and following the transaction.

(c) It has provided that in applying the percentage tests referred to above, assets contributed to, bought by, or otherwise acquired by the partnership in the 12-month period immediately before the transaction in question are not to be taken into account unless there was a bona fide business purpose for the contribution, purchase, or acquisition of the property by the partnership.

(5) In section 764, relating to the closing of a partnership year for a deceased partner, your committee has provided that, for the successor of a partner who elects to continue the partnership year with respect to a deceased partner beyond his date of death, the partnership year is not to close prior to the normal ending of the partnership year even though the successor has disposed of part of the interest in the partnership before that time. The partnership year with respect to such an interest will close, however, at the time of the disposition where all of the interest is disposed of in this interval, in the same manner as provided under the House bill.

(6) In section 765, relating to sales or exchanges of property with respect to controlled partnerships, your committee made two technical amendments.

(7) In section 770, relating to an interest in partnership capital exchanged for services, your committee has modified the House provision to provide that partners given an interest in partnership capital in exchange for services are not to include in their taxable income any value of the interest attributable to appreciation in ordinary income items which subsequently will be reported when the income is realized by the partnership.

(8) Your committee has modified the House amendment to section 1014(c), relating to basis of property acquired from a decedent by providing that nothing in the amendment is to prevent an increase in the basis of an interest in a partnership of a deceased partner attributable to his share of the partnership income in the portion of the year before his death if this income remained in the partnership at the time of his death.

II. GENERAL EXPLANATION OF THE PROVISIONS OF TITLE I

Section 641. Imposition of tax (sec. 101 of bill)

(1) Section 641(c). Legal life estates (sec. 101(a) of bill)

Section 101(a) of the House bill added a new subsection (c) to section 641 to deal with problems arising from the sale, etc., of property subject to legal life estates or other terminable legal interests. Your committee has been advised that recent court decisions eliminate the need for such legislation and, therefore, has deleted this provision from the bill.

(2) Section 641(a)(2). Income collected by a guardian (sec. 101(a) of bill)

Section 101(b) of the House bill amends sections 641(a)(2) by striking out the phrase—

, and income collected by a guardian of an infant which is to be held or distributed as the court may direct.

Inasmuch as such income is not presently taxed under subchapter J, the deletion merely clarifies the law. Your committee's bill retains this amendment as section 101(a) of the bill.

(3) Section 641(c). Multiple trusts (sec. 101(b) of bill)

The bill as amended by your committee adopts a new approach to the multiple-trust problem, replacing that contained in section 113 of the House bill.

The multiple-trust provisions of the House bill have been criticized on the grounds that they are unnecessary, or that they are not responsive to the problem, or that they are unsatisfactory in one or more particulars. Your committee believes that multiple trusts constitute an abuse, both present and potential, which requires immediate corrective legislation. However, your committee has adopted an approach which endeavors to meet some of the criticisms of the House bill.

The approach adopted by the House was one which, generally speaking, had the effect of treating trusts as multiple trusts if (1) the same person contributed property to the trusts, (2) the trusts coexisted at any time, and (3) the trusts made accumulation distributions (specially defined for this purpose and called "sec. 669 distributions") to the same beneficiary. Once trusts were determined under these rules to be multiple trusts, any beneficiary receiving section 669 distributions from two or more such trusts would be subjected to a tax computed under a special 10-year throwback rule on all such distributions (other than those from the trust from which he first received such a distribution, i.e., the "primary trust").

The multiple-trust problem stems from the fact that tax rates applicable to income taxable to a trust are graduated rates, as distinguished from a flat rate. The problem consists essentially in a division of trust taxable income for any given taxable year among two or more trusts. Through such a division tax benefits can be obtained which are equal to the difference in the tax which would be applicable to one trust and that payable by the separate trusts among which the income is divided. Viewed conceptually, the problem can arise only where a trust has income which is taxable to it, and does not arise, generally speaking, in years during which the trust has no taxable income (as, e.g., where the trust is required to or in fact does distribute all its income currently), or during years in which it does not distribute all its income currently and has taxable income but is in effect not taxable as an entity (as, e.g., where its income is taxable to the grantor under the so-called "Clifford" provisions). Moreover, although the problem may arise even in other contexts, it is generally viewed as existing principally where the trust taxable income which is divided among two or more trusts in any given year is attributable to contributions of property by the same settlor and may be payable, or is in fact paid, to substantially the same beneficiary or beneficiaries.

At the hearings held by your committee, the multiple-trust provisions of the House bill were criticized on several grounds. It was pointed out that the House bill applies to trusts which are not "multiple trusts" and imposes a tax which is unrelated to the benefits obtained through the use of multiple trusts. For example, the provisions of the proposed section 669 would treat two trusts (which otherwise qualify) as multiple trusts if they merely co-exist at any time, even though during the period of co-existence there is no one taxable year or other period for which the two trusts both have taxable income. It was also observed that the technique adopted in section 669 for computation of the tax with respect to multiple trust distributions—namely, a special 10-year throwback rule under which section 669 distributions are includible in income of the distributee as if distributed at the close of the year from which it is deemed distributed—may result in a tax which has no relation to the benefits derived from the use of multiple trusts and which therefore may be either more or less than such benefits. In addition, it was noted that the deterrent effect of section 669 would be considerably reduced by reason of the "tax-free" buildup which would be permitted. Your committee does not agree with such results and believes a substitute approach is needed.

In the provisions of section 641(c), added by section 101(b) of the bill, your committee has adopted, with certain modifications, the approach recommended by the Advisory Group on Subchapter J in its "Final Report to the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means." Your committee feels that this approach more effectively meets the problem presented.

The approach adopted in the provisions of the new section 641(c) is essentially an "aggregation approach"; that is, one in which designated income of separate trusts (regarded as multiple trusts) is required to be aggregated and taxed as if it had occurred in one trust. Any additional tax resulting from the aggregation is imposed on and allocated among the several trusts, the income of which is aggregated. For purposes of determining whether trusts are multiple trusts and for purposes of effecting the required aggregation, trusts are classified into two groups—inter vivos trusts and testamentary trusts. The trusts in one such group cannot be combined with trusts in the other group. In order to prevent the necessity of making an aggregation with respect to separate trusts in certain cases, there are provisions which eliminate the aggregation requirement. With respect to inter vivos trusts, the provisions will not apply (1) where the combined designated incomes of the separate trusts aggregate less than $2,000, or (2) where the separate trusts do not exceed two in number and are created not less than 96 months apart. With respect to testimentary trusts, the provisions will not apply where the designated incomes of the separate trusts aggregate less than $2,000.

Generally speaking, incomes of separate trusts are required to be aggregated only if and to the extent (1) that such incomes for any year or portion of a year are either "currently accumulated income" or "taxable income allocable to corpus"; (2) that during such year or portion of a year the "primary beneficiary or beneficiaries" of such incomes are "substantially the same"; (3) that such incomes are considered to be attributable to trust property which is contributed by (or is attributable to property contributed by) the same person, and (4) that such incomes of the separate trusts are attributable to the same period.

Only that income which is "currently accumulated income" or "taxable income allocable to corpus" is taken into account. The concept of "currently accumulated income" has reference to amounts which are considered to be income under applicable local law.

The incomes of separate trusts may be taken into account in making the aggregation only to the extent that during any year (or portion of a year) the "primary beneficiary or beneficiaries" of currently accumulated income or taxable income allocable to corpus are "substantially the same." The term "primary beneficiary or beneficiaries" is defined by section 641(c)(4)(C) to mean the beneficiary or beneficiaries to whom the accumulated income or taxable income allocated to corpus "would first be distributed" where there is an order of succession with respect to such income or taxable income. For purposes of determining the identity of the beneficiary or beneficiaries to whom such income "would first be distributed," it is intended that the determination be made as of the close of the year or portion of a year to which the income is attributable. For purposes of making this same determination, the phrase "beneficiary or beneficiaries to whom income would first be distributed" has reference to the person or persons (determined as of the time specified in the preceding sentence) to whom such income would first be distributed in the event that distribution of such income were made at the time or times at which, under the terms of the governing instrument or applicable local law, such distribution is first to be made. Since the making of a distribution, and the time for making it, to any particular person will commonly depend on the occurrence or failure of occurrence of one or more events or contingencies, the determination at any time of the identity of the primary beneficiary or beneficiaries will necessarily have to be made by appropriate reference to external circumstances. The estate of the holder of a testamentary general power of appointment is treated as the primary beneficiary of "taxable income allocated to corpus." This will limit the application of section 641(c) to the common cases in which the surviving spouse is the beneficiary of such taxable income of both a marital deduction trust and of a family trust. Generally speaking, the possible appointees under a power of appointment other than a testamentary general power shall be considered to be the primary beneficiaries of currently accumulated income or taxable income allocated to corpus subject to such power.

The incomes of separate trusts may be taken into account in making the aggregation only to the extent considered to be attributable to trust property contributed by the same settlor. Thus, if all the property of two trusts has been contributed by only one person, all the income of both the trusts may be taken into account, even though the property to which the income is attributable is not the property originally contributed by the settlor but is property which, in the course of investment, reinvestment and administration of trust assets, has been substituted for or added to the property originally acquired. If, on the other hand, the property of two trusts has been contributed by two or more persons, only that portion of the income of each of the trusts which is attributable to property contributed by a person (or persons) who contributed to both trusts may be taken into account in making the aggregation. Whether income is attributable to property contributed by a particular grantor is a question of fact to be determined from all facts and circumstances. Where it can be established that income of a trust is attributable to property contributed by a particular grantor, income of the trust will, of course, to that extent be regarded as income attributable to property contributed by that particular grantor. In the absence of evidence to the contrary, income of a trust to which two or more grantors contributed property will be regarded as attributable proportionately to the property attributable to each of the grantors.

In the event that an aggregation is required under section 641(c), the method for computing the total tax payable by the separate trusts (in order to determine the tax resulting from the application of section 641(c)) and for allocating and assessing it among the several trusts, is to be prescribed by regulations. The method to be prescribed for computing the tax is, of course, subject to the general rule prescribed by the statute to the effect that the total tax payable by the separate trusts with respect to the income which is required to be aggregated shall be computed as though the separate trusts were one trust with respect to such income. Although it is "currently accumulated income," as determined under applicable local law, which is to be taken into account in determining whether an aggregation is to be made and for purposes of making the required aggregation, only that portion thereof which is reflected in taxable income is subject to tax. Thus, if all the currently accumulated income happens to be exempt from tax for Federal income tax purposes, when it is aggregated none of it would be reflected in taxable income and none of it would be subject to tax.

Paragraph (3) of section 641(c) provides a flat 25-percent rate with respect to long-term capital gains which are included in the income upon which a tax is computed under section 641(c) (1) or (2).

Section 641(c) (6) of your committee's bill broadens the disclosure of information provisions contained in paragraph (5) of the House bill. It provides that the Secretary or his delegate may require the grantor of two or more trusts, or his personal representative, or the trustee of any trust, to furnish such information with respect to such trust as reasonably appears to the Secretary or his delegate necessary to carry out the purposes of section 641(c). The provision also permits the Secretary or his delegate to furnish to the fiduciary of a trust information obtained with respect to another trust whose income may enter into the computation of tax under section 641(c).

Section 102(c) of your committee's bill amends section 642(d) to deny the net operating loss carryback to multiple trusts. The amendment denies the carryback only with respect to a year for which the provisions of section 641(c) (1) or (2) apply.

Section 119 (h) and (i) of your committee's bill amends section 6501 to provide a 6-year statute of limitations with respect to the assessment or refund of taxes to the extent such tax is attributable to currently accumulated income or taxable income allocated to corpus which is required to be combined under section 641(c) (1) or (2).

Section 642. Special rules for credits and deductions (sec. 102 of bill)

(1) $50 dividend exclusion (sec. 642(a)(3))

Section 116(a) excludes from gross income certain dividends received by an individual to the extent that the dividends do not exceed $50. Where an estate or trust receives dividends which qualify for the exclusion but distributes a part of such dividends to a beneficiary during the taxable year, present regulations require that a ratable part of the $50 dividend exclusion be denied to the estate or trust. For example, if an estate or trust receives $1,000 in qualifying dividends of which it distributes $500 to beneficiaries, the estate or trust is entitled to exclude only $25 of the undistributed dividends.

Section 102(a) of the House bill amends section 642(a)(3) to allow a trust or estate the full $50 dividend exclusion under section 116(a) if the fiduciary retains undistributed dividends qualifying under section 116(a) in that amount. Your committee concurs in the amendment made in the House bill but has clarified the language thereof. Under the House bill, and your committee's bill, the proration requirement of present law with respect to dividends which do not qualify under section 116(a) (for example, foreign dividends) is retained.

(2) Deduction for charitable contributions (sec. 642(c))

Under present section 642(c), an estate or trust is allowed an unlimited deduction against its gross income for any amount of gross income which is paid or permanently set aside for a charitable purpose specified in section 170(c) or used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit. As interpreted by the courts (*Old Colony Trust* v. *Com.*, 301 U.S. 379 (1937)), the deduction is allowed for charitable distributions from undistributed gross income of prior years, as well as from gross income of the current year. Thus, the charitable deduction requires tracing to determine whether the amount distributed to charity was an item of gross income of the current or a prior year.

Moreover, because a distribution to a charitable beneficiary is treated as a deduction from gross income under section 642(c), whereas a distribution to a noncharitable beneficiary is allowed as a deduction with respect to distributable net income under sections 651 and 661, a number of complicating adjustments are required. Where an estate or trust has both charitable and noncharitable beneficiaries, the statute requires separate computations in preparing the income tax return. Also, in allocating the items of income included in distributions to charitable and noncharitable beneficiaries, the same item of income is allocated in two diffierent ways. This requires other complex adjustments and may produce artificial results.

In order to simplify the law and to eliminate the necessity for numerous complicating adjustments, and to simplify the administration of trusts and estates, your committee proposes to treat charitable distributions by trusts and estates as distribution deductions under section 661. Section 102(b) of your committee's bill, like the House bill, is the first of a series of amendments required to accomplish this result. It amends section 642(c) to deny a deduction for charitable contributions, except to the extent provided in section 661. Such a disallowance is necessary to prevent a double deduction.

Further amendments necessary to carry out the proposed change are contained in other sections of the bill. Conforming amendments made to sections of the code outside of subchapter J are contained in section 119 of the bill.

(3) Net operating loss deduction (sec. 642(d))

Section 102(c) of your committee's bill amends section 642(d) to deny a net operating loss carryback to a trust with respect to a year to which section 641(c) (1) or (2) (relating to multiple trusts) applies.

(4) Deduction for depreciation and depletion (sec. 642(e))

Section 102(d) of your committee's bill, like the House bill, amends section 642(e) by striking the word "allowable" and inserting in lieu thereof "apportioned." The amendment makes it clear that a portion of any depreciation or depletion allowances to which a trust or estate is entitled should be allocated to charitable as well as noncharitable beneficiaries. This is intended to be declaratory of existing law.

(5) Unused loss carryovers and excess deductions (sec. 642(h))

Upon the final termination of an estate or trust, section 642(h) of present law permits the beneficiaries who succeed to the property to deduct a proportionate share of any unused net operating loss carryover, unused capital loss carryforward, or other excess deductions of the estate or trust.

Since the provision applies only to final terminations, none of the specified items of deduction are available to a beneficiary where there is a termination of such beneficiary's entire interest in the estate or trust. Section 102(e) of your committee's bill, like the House bill, makes section 642(h) applicable on the termination of a single beneficiary's entire interest in an estate or trust having more than one beneficiary where such interest constitutes a separate share. The amendment provides that separate and independent shares of beneficiaries in a trust or estate, as determined pursuant to section 663(c), shall be treated as separate trusts or estates. The continuing trust cannot deduct that portion of the excess deductions and unused loss carryovers allocated to such a beneficiary.

(6) Deduction for estate tax on income in respect of a decedent (sec. 642(i))

Section 102(f) of your committee's bill, like the House bill, amends section 642 by adding a new subsection (i) to allow an estate or trust a deduction for estate tax paid on income in respect of a decedent which is properly attributable to the estate or trust. The balance of the deduction would be allowable to the beneficiaries to whom the remaining income in respect of a decedent is allocable. This is intended to be declaratory of existing law.

Section 643. Definitions (sec. 103 of bill)

(1) Deduction for personal exemption and for estate tax (sec. 643(a)(2))

Since section 642(i) allows the deduction under section 691(c) for the estate tax attributable to the income in respect of a decedent received by an estate or trust, a double benefit would result if such deduction were allowed also to reduce distributable net income. Therefore, section 103(a) of your committee's bill, like the House bill, amends section 643(a)(2) to deny the deduction under section 691(c) for estate tax on income in respect of a decedent for purposes of computing distributable net income. This is intended to be declaratory of existing law.

(2) Capital gains and corpus items of deduction (sec. 643 (a)(3))

Under present law capital gains are included in distributable net income and are taxable to the beneficiaries only to the extent they are paid, credited, or required to be distributed during the taxable year. If capital gains are allocated to corpus and are not paid, credited, or distributed to any beneficiary or permanently set aside for charitable purposes, they are excluded from distributable net income. However, it is not clear whether a distribution of corpus will be deemed to include a portion of capital gains realized during the same taxable year.

The amendment of section 643(a)(3)(A) made by section 103(b) of your committee's bill, like the House bill, is a conforming amendment required to carry out the proposed treatment of charitable beneficiaries. It deletes the reference to section 642(c) but retains the effect of present law by providing that capital gains which are permanently set aside or used for specified charitable purposes shall not be excluded from distributable net income. Your committee's bill amends section 103(b) of the House bill to make it clear that capital losses are excluded in computing distributable net income except to the extent that such losses are utilized in determining the amount of capital gains which are (1) paid, credited or required to be distributed, or (2) permanently set aside or to be used for charitable purposes.

Section 103(b) of your committee's bill, like the House bill, also amends section 643(a)(3) by adding a new subparagraph (B) which provides that capital gains shall not be considered paid, credited, or required to be distributed (and therefore will be excluded from distributable net income) unless at least one of the following requirements is met: (1) they are required to be distributed currently under the governing instrument or local law; (2) they are not required to be distributed currently, but the books of the fiduciary or notice to the beneficiary shows an intention to pay or credit such amounts to the beneficiary during the taxable year; (3) the fiduciary follows the regular practice of distributing all capital gains; (4) the capital gains are received in the year of termination of the estate or trust, or (5) the capital gains are received in the year of termination of an entire separate share of an estate or trust. Your committee believes that the amendment will clarify present law by establishing rules for determining when a distribution of corpus will be deemed to include a portion of the capital gains realized during the taxable year.

Under present law all deductible charges against an estate or trust, whether paid from income or from corpus, are allowed as deductions in computing distributable net income, so that the primary benefit of the deductions inures to the income beneficiaries. Only to the extent that such deductions exceed distributable net income are they allowed to offset corpus income taxable to the trust. Hence, even where the deductions are properly chargeable against corpus and borne by the remaindermen, they are allowed first to benefit the income beneficiaries and thus, in many instances the remaindermen are improperly deprived of tax deductions. Your committee believes that the benefit of corpus deductions should not be shifted to the income beneficiaries where gross income remains taxable to the estate or trust.

Therefore, your committee's bill, like the House bill, adds subparagraph (C) to section 643(a)(3) to provide that corpus deductions shall first be applied against income which is allocable to corpus and taxable to the trust or estate. This amendment allows the benefit of corpus deductions first to the corpus beneficiaries who ultimately bear the tax burden. Only the excess of corpus deductions which the trust cannot use to offset corpus income are permitted to reduce distributable net income for the benefit of the income beneficiaries. The amendment will continue the policy of present law to avoid wastage of deductions and, at the same time, will result in more equitable treatment of the remaindermen with respect to deductions chargeable against corpus. Clause (ii) of section 643(a)(3)(C), which is added by section 103(b) of the House bill, has been amended by your committee to exclude distribution deductions allowed by section 643(a)(1) in determining the amount of corpus deductions which are excluded in the determination of distributable net income. It should be noted, however, if the alternative method under section 1201 is used in computing the tax on capital gains, the corpus deductions otherwise available are not permitted to reduce distributable net income for the benefit of the income beneficiaries.

(3) *Foreign income (sec. 643(a)(6))*

In the case of a foreign trust section 643(a)(6) provides that distributable net income shall include amounts of gross income derived from sources outside the United States. Section 103(c) of the bill amends section 643(a)(6) to make it applicable to a "foreign estate" as well as a foreign trust.

(4) *Conforming amendment (sec. 643(a))*

Section 103(d) of your committee's bill amends section 643(a) by striking out the last two sentences. This amendment eliminates the references to section 642(c) (relating to charitable, etc., deductions), and conforms the law to your committee's proposed treatment of charitable contributions as distribution deductions.

(5) *Definition of income (sec. 643(b))*

Section 103(e) of the bill adds capital gains to the items which are not to be considered income (under section 643(b)) when under the terms of the governing instrument and applicable local law they are properly allocable to corpus. This change merely clarifies present law.

(6) *Clerical amendment (sec. 643(c))*

Section 103(f) of your committee's bill makes a clerical amendment.

(7) *Definition of charitable beneficiary (sec. 643(d))*

Section 103(g) of the House bill amended section 643 of existing law by adding a new subsection (d) defining "charitable beneficiary" for purposes of part 1 of subchapter J. The term "charitable beneficiary" is there defined to mean any beneficiary to or for the use of which a contribution by an individual would be a "charitable contribution" under section 170(c) (without regard to the percentage limitations described in section 170(b)). This proposed definition of "charitable beneficiary," in combination with the deduction for amounts paid or permanently set aside for a "charitable beneficiary" allowable under section 661(a)(4) as proposed to be amended by section 106(a) of the House bill, created the possibility of an unintended change in the present law relating to permissible "charitable beneficiaries" of trusts and estates. At the present time section 642(c) permits a deduction for amounts of gross income paid or permanently set aside for "a *purpose* specified in section 170(c)." There is no requirement that the beneficiary be a beneficiary to or for the use of which a contribution by an individual would be a charitable contribution under section 170(c). The restricted definition of "charitable beneficiary" in the House bill would not, for example, adequately cover a charitable trust which uses its income directly for charitable purposes but does not funnel it through an organization.

To avoid the possibility of such an unintended change in present law, your committee has deleted from the House bill the proposed definition of "charitable beneficiary" and has amended section 661(a)(4), as proposed to be amended by section 106(a) of the House bill, to delete the reference to a "charitable beneficiary (as defined in section 643(d))" and substituted instead a reference to a "purpose described in section 170(c)." In addition, your committee has made a conforming amendment to section 651(a)(3), as proposed to be amended by section 104 of the House bill so as to change the reference to "charitable beneficiaries" to "charitable purposes."

Section 651. Deduction for trusts distributing current income only (sec. 104 of bill)

(1) Deduction (sec. 651(a))

Section 104 of your committee's bill amends section 651(a) to conform it to proposed changes in the treatment of charitable contributions.

(2) Limitation on deduction (sec. 651(b))

Section 651(b) of present law limits the deduction allowable to a trust under section 651(a) to the lesser of the "income required to be distributed currently" or the "distributable net income." For this purpose, distributable net income is reduced by tax-exempt items not included in gross income, but the statute does not specifically provide that "income required to be distributed currently" shall be reduced by exempt items of income.

Section 104 of the House bill amended section 651 (b) to make it clear that the computation of both "distributable net income" and "income required to be distributed currently" must be reduced by all items of income which are not included in the gross income of the trust for purposes of determining the amount of the distribution deduction under section 651. The House amendment also made it clear that the character of such items was to be determined by reference to the rules in section 652(b).

Your committee concurs in the objective of the House amendment but it has been pointed out to the committee that the limitation may not apply where the amount of the taxable income and the amount of the tax-exempt income of a trust are identical. In order to make clear the results intended, your committee's amendment adopts the limitation language used in section 661(c).

Section 652. Inclusion of amounts in gross income of beneficiaries (sec. 105 of bill)

(1) Character of amounts (sec. 652(b))

Section 105(a) of your committee's bill, like the House bill, is a technical amendment to section 652(b) which is intended to be declaratory of existing law.

(2) Different taxable years (sec. 652(c))

Section 652(c) provides that if the taxable year of the beneficiary is different from that of the trust, the amount of gross income taxable to the beneficiary is based on the income of the trust for the year or years of the trust ending within or with the beneficiary's taxable year. The language of existing law is not explicit where, for example, because of the death of the beneficiary, there is no taxable year of the trust ending with or within the beneficiary's last taxable year.

Section 105(b) of the House bill amended section 652(c) to make clear the amount of income of a trust which is includible in the final return of a beneficiary. It provided that there shall be included in the final return of a beneficiary who dies during the taxable year of the trust or estate, such beneficiary's share of income of the estate or trust up to the time of his death, reduced by expenses properly charged against such share of income, whether paid before or after the date of death of the beneficiary.

Under the House bill "bunching" of income might result from the application of both paragraphs (1) and (2) of section 652(c), as proposed to be amended by the House bill, to a beneficiary in certain cases, by requiring the inclusion in the final return of the beneficiary of as much as 23 months of income of the trust or estate. In order to alleviate the tax effects of such "bunching" of income in one taxable year of the beneficiary, your committee has adopted an amendment providing that if amounts are includible in the beneficiary's return by reason of both subparagraph (A) and subparagraph (B) of paragraph (1) of section 652(c) (corresponding to pars. (1) and (2) of sec. 652(c) as proposed to be amended by the House bill), the tax attributable to the amount includible by reason of subparagraph (B) of paragraph (1) shall not be greater than the aggregate of the taxes attributable to such amount had that amount been includible in the gross income of such beneficiary ratably in the taxable year in which the beneficiary's death or other termination of existence occurs, and the 2 preceding taxable years.

Your committee's amendment thus imposes a ceiling on the amount of taxes attributable to the amount includible by reason of subparagraph (B) of paragraph (1), where amounts are includible in the gross income of the beneficiary by reason of both subparagraphs (A) and (B) of paragraph (1).

Section 661. Deduction for estates and trusts accumulating income or distributing corpus (sec. 106 of bill)

(1) Deduction for estates and trusts (sec. 661(a))

Under your committee's bill, as under the House bill, the deduction for charitable contributions from gross income under section 642(c) is denied (see discussion under sec. 102(b)), and in order to effectuate the proposed treatment of charitable contributions, it is necessary to amend section 661(a) to provide for the allowance of the deduction to an estate or trust.

Section 106(a) of the House bill amended section 661(a) to allow a deduction to an estate or trust for any amounts paid or permanently set aside for a "charitable beneficiary" (as defined in sec. 643(d)) or to be used for certain specified purposes. The House bill permitted a deduction for such amounts whether such amounts were from gross income or from corpus. The aggregate deduction allowed under the House bill for amounts distributed to all beneficiaries, charitable and noncharitable, and amounts permanently set aside, or to be used for charitable purposes was limited to the amount of distributable net income of the estate or trust. Further, the charitable deduction under section 661(a)(4) of the House bill could not exceed an amount equal to the distributable net income of the estate or trust for the taxable year, reduced by the amounts specified in paragraphs (1), (2), and (3) of section 661(a) (relating to amounts distributed to noncharitable beneficiaries).

Your committee has amended section 661(a), as it appears in the House bill, in a number of respects. Section 661(a)(3) is amended to include therein all amounts properly paid for one or more purposes described in section 170(c). The latter amounts are described in section 661(a)(3)(B) of your committee's bill. Section 661(a)(3) of the House bill becomes section 661(a)(3)(A) of your committee's bill. This change also conforms section 661(a)(3) of your committee's bill to section 662(a)(3) of your committee's bill for the reasons set forth in the discussion under section 662.

For the reasons set forth in the discussion relating to your committee's deletion of section 643(d) (adding a definition of "charitable beneficiary"), as proposed to be added by the House bill, your comcommittee has deleted the reference to "charitable beneficiary" in section 661(a)(4) of the House bill and substituted instead a reference to "one or more of the purposes described in section 170(c)."

In addition, your committee has limited section 661(a)(4), as proposed by the House bill, to amounts *permanently set aside* for one or more of the purposes described in section 170(c) or *to be used* exclusively for religious, charitable, scientific, etc., purposes. Further, under your committee's amendment to section 661(a)(4), only amounts of *gross income for the taxable year* which, pursuant to the terms of the governing instrument, are permanently set aside or to be used for the described purposes will qualify for the deduction under section 661(a)(4). This is in contrast to section 661(a)(4) as proposed by the House bill under which any amount which, pursuant to the terms of the governing instrument, would qualify under section 661(a)(4) (provided the other conditions were met) whether the amount was set aside out of gross income for the taxable year, gross income of prior taxable years, or from corpus.

Other amendments made by section 106(a) of your committee's bill conform the provisions of section 661(a) to the changes made by your committee's bill in the tier system in 662(a).

(*2*) *Character of amounts* (*sec. 661*(*b*))

The amendment made by section 106(b) of your committee's bill, like the House bill, conforms section 661(b) to the change in treatment of charitable beneficiaries.

Section 662. Inclusion of amounts in gross income of beneficiaries of trusts accumulating income or distributing corpus (*sec. 107 of bill*)

(*1*) *Inclusion by the beneficiary* (*sec. 662*(*a*))

Under present law, in general, amounts distributed by an estate or trust (whether current income, accumulated income, or corpus) are includible in the gross income of the recipients to the extent of distributable net income. Where there is more than one beneficiary receiving distribution, it is necessary to determine the order of priority in which distributions to beneficiaries shall be deemed to consist of income distributed by the trust. This is accomplished by a mechanical device known as the "tier system" and section 662 of present law established a "two-tier" system for this purpose. In general, the distributable net income of the trust or estate is deemed to be paid first to those beneficiaries receiving income required to be distributed currently (first tier), and then, as to any remaining distributable net income, to all other beneficiaries (second tier). Thus, beneficiaries receiving discretionary distributions of income are placed in the same class or tier with those beneficiaries receiving distributions from corpus for purposes of allocating trust or estate income. As a consequence, if distributions to required income beneficiaries (tier one) do not use up the full amount of distributable net income, a beneficiary who can receive distributions only out of corpus is taxed on a pro rata share of the distributable net income (along with a beneficiary receiving discretionary payments out of income) even if the distributable net income was in fact only sufficient to satisfy the distributions to the income beneficiaries.

Since charitable distributions under present law are allowed as a deduction from gross income under section 642(c), such distributions are excluded from the tier system established in section 662. Under existing section 662(a)(1) (relating to first tier beneficiaries) distributable net income is computed without regard to the charitable deduction, whereas under section 662(a)(2) (relating to second tier beneficiaries) distributable net income retains the definition set forth in section 643(a), which takes the charitable deduction into account in arriving at distributable net income. Hence, any distributable net income remaining after an allocation is made to the first tier beneficiaries is allocated to the charitable deduction before being allocated to beneficiaries coming within the second tier. Thus, under present law in the case of a trust which requires the current income to be paid to charity, and an equal amount of corpus to be paid to Y, Y is not taxed on the amount he receives.

Under the House bill a three-tier system of allocation was adopted under which the distributable net income of an estate or trust was taxed to beneficiaries in the following order of priority:

First tier.—Beneficiaries receiving mandatory or discretionary distributions which could be paid only from current income:

Second tier.—Beneficiaries entitled to receive discretionary distributions which may be paid out of either current income or corpus (including accumulated income of prior years); and

Third tier.—Beneficiaries entitled to receive distributions only out of corpus (including accumulated income of prior years).

The House bill provided a special rule with respect to the treatment of charitable contributions and charitable beneficiaries. For reasons of simplification and to preclude the possibility of tax avoidance, charitable distributions were placed in the equivalent of a fourth tier. This was accomplished by section 107(a) of the House bill which established an order of priority for allocating the distributable net income of the trust or estate to beneficiaries, other than charitable beneficiaries. The result was that noncharitable beneficiaries were required to include in their income all amounts distributed, to the extent of distributable net income of the trust or estate, unreduced by any distributions to charity.

Your committee has made a number of modifications in section 662 as proposed to be amended by the House bill. In the House bill it appeared that the *identity* of the beneficiary rather than the *character or source* of a particular payment, as between income and corpus, to the beneficiary, may have been determinative of the applicable tier for such payment. Instead of letting the character or source of the payment determine the appropriate tier for the payment, the language of the House bill could be construed to shift to the identity of the beneficiary and made the identity of the beneficiary determinative of the applicable tier. As a result, it was difficult to apply the section, for example, to a particular discretionary payment which could come only from income where the same beneficiary was also the recipient of another discretionary payment which came from corpus.

Your committee makes it clear that it is the character or source of payment as between income and corpus, rather than the identity of the beneficiary, that is determinative of the applicable tier of the particular payment. To accomplish this, your committee has changed the words in section 661(a)(1), as proposed to be amended by the House bill, reading "to a beneficiary to whom no amount may be paid or credited during the taxable year except from income for the taxable year" to read "to a beneficiary only out of income for the taxable year." To accomplish its objective in section 662(a)(2), it changed the words "to a beneficiary to whom amounts may be paid or credited during the taxable year out of income for the taxable year or out of corpus (including accumulated income of prior taxable years)" to read "to a beneficiary either out of the income for the taxable year or out of corpus (including accumulated income of prior taxable years)." These changes make it clear that a beneficiary may be in tier 1 with respect to one payment, in tier 2 with respect to another payment, and in tier 3 with respect to a third payment.

In addition your committee has amended section 662(a)(1), as proposed to be amended by the House bill, to make the term "paid or credited" read "properly paid or credited" to conform to the term in section 662(a)(3) of such bill and to existing law. It also made a similar change in section 662(a)(2), as proposed to be amended by the House bill.

Tier 2 (sec. 661(a)(2)) of the House bill was limited to *discretionary* payments which could be made out of either income or corpus (including accumulated income of prior years). Under your committee's amendment, *mandatory* payments of the same character will also be in tier 2. Under your committee's amendment, tier 2 will embrace any amount (other than amounts paid, set aside for or to be used for charitable purposes) properly paid or credited (whether the amounts paid or credited were paid or credited pursuant to a mandatory requirement to do so, or to the exercise of a discretion in the fiduciary to do so) or required to be distributed to a beneficiary in the exercise of a discretion by the fiduciary to pay, credit or distribute such amount to a beneficiary either out of income for the taxable year or out of corpus (including accumulated income of prior taxable years). Hence, under your committee's bill, tier 2 will include a payment of an amount which is *required* to be made by a fiduciary to a beneficiary, where the source of the payment may be, in the discretion of the fiduciary, either income or corpus (including accumulated income of prior taxable years) of the trust.

Under the House bill, noncharitable beneficiaries were required to include in their income all amounts distributed to the extent of the distributable net income of the trust or estate, unreduced by any distribution to charity. Under the House bill, where a trust instrument provided that all of its income was to be currently distributed to a charity, and an equal amount of corpus was to be paid to an individual beneficiary, the individual beneficiary would be taxed on the entire distribution to him up to the extent of the distributable net income. Your committee believes that payments actually and properly *made* (whether from income or corpus, including accumulated income of prior years) for one or more of the purposes described in section 170(c), as distinguished from those amounts *permanently set aside* for such purposes or *to be used* for charitable, etc., purposes, should fall in tier 3 (secs. 661(a)(3) and 662(a)(3)) along with all other amounts properly paid or credited or required to be distributed to a noncharitable beneficiary during the taxable year. In the example given above, under the House bill the individual beneficiary would be taxed on the entire distribution to him up to the extent of the distributable net income of the trust. Under your committee's amendment, the individual beneficiary in that example would be taxed on only one-half of the distributable net income since the individual beneficiary received only half of the total amounts distributed and described in tier 3 (and no other distributions were made to anyone other than that of an equal amount made to charity). The other one-half of the amount distributed and described in tier 3 was paid for one or more of the purposes described in section 170(c).

Where a grantor establishes a short-term charitable trust meeting the requirements of section 674(b), the separate share rule as applied to successive interests (regulations sec. 1.663(c)-3(e)) prevents the income of the trust for the year of termination from being taxed to the grantor under the tier system. And when the corpus reverts to the grantor *after* the termination of such a trust, the grantor is not taxed on the corpus at the time of such reversion.

(*2*) *Character of amounts* (*sec. 662*(*b*))

Section 107(b) of the House bill and your committee's bill amends section 662(b) to conform the character rules with the amendments changing the treatment of distributions to charitable beneficiaries.

(*3*) *Different taxable years* (*sec. 662*(*c*))

Section 107(c) of the House bill amended section 662(c) to make clear the amount of income of an estate or complex trust which is includible in the final return of a beneficiary. In order to alleviate the tax effects of such "bunching" of as much as 23 months of income, that may occur in certain cases under the House bill, your committee has adopted an amendment to section 662(c) substantially the same as your committee's amendment to section 652(c). See the discussion of the latter amendment in connection with section 105(b) of the bill.

Section 663. Special rules applicable to sections 651, 652, 661, and 662 (sec. 108 of bill)

(*1*) *Exclusions* (*sec.* 663(*a*))

(i) *Gifts, bequests, etc., of specific sums of money or of specific property.*—Under section 663(a)(1) of present law gifts or bequests of a specific sum of money (other than those which can be paid only out of income) or of specific property which, under the terms of the governing instrument, are paid all at once or in not more than three installments (regardless of when paid) are excluded from amounts falling within sections 661(a) or 662(a). Thus, the estate or trust does not get a deduction under section 661(a) for payment of such specific gifts or bequests of corpus, and the distribution is not taxable to the recipient under section 662(a).

Section 108(a)(1) of the House bill amended section 663(a)(1) to eliminate inter vivos trusts from the provisions of section 663(a)(1), except for those which, immediately before the grantor's death, were revocable by the grantor acting alone. Your committee's amendment eliminates all inter vivos trusts and makes the provisions of section 663(a)(1) applicable only to estates and testamentary trusts. Your committee believes that the exclusions provided by section 663(a)(1) of present law are extremely broad and are subject to possible abuse and believes that the scope of these exclusions should be narrowed. Although the House bill narrows the scope of the provisions, the bill as amended by your committee would further limit the scope of the exclusions by making the provisions of section 663(a)(1) applicable only to estates and testamentary trusts. The bill retains the exclusion for lump-sum gifts or bequests which are paid all at once, but expands the concept to permit payment in any one taxable year.

The bill also amends the "three installment rule" of present law to permit, in general, an exclusion for gifts and bequests in any number of installments, provided they are paid before the close of the 36th calendar month which begins after the date of death of the decedent. This latter exclusion is not applicable if a gift or bequest is required, under the terms of the governing instrument, to be paid or distributed in installments in whole or in part after the close of such 36-month period.

(ii) *Other gifts, bequests, etc.*—It has come to the attention of your committee that the present exclusionary provision in section 663(a) often results in inequities, particularly with respect to corpus distributions by estates. For example, distributions of corpus to residuary legatees, payments solely out of corpus to will contestants, and payments out of corpus to widows pursuant to local law may not be excluded by present law. As a result, distributions to beneficiaries from the residue of an estate sometimes result in a beneficiary being taxed with a disproportionate share of income.

Section 108(a)(1) of the House bill and your committee's bill adds a new paragraph (2) to section 663(a) which, in conjunction with the amendment to section 663(c) (relating to the separate share rule), is designed to remove such inequities arising under present law. The amendment adopts a "distributions in kind" approach to permit exclusions for distributions from an estate of real property or tangible personal property owned by the decedent at the date of his death, which are properly paid in satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate before the close of the 36th calendar month which begins after the date of death of the decedent.

Paragraph (2) of section 108(a) of the House bill has been amended by your committee to expand the exclusions for distributions from the corpus of an estate so as to include distributions of "closely held stock," as well as real property or tangible personal property, owned by the decedent at the date of his death. Under the amendment "closely held stock" is defined as stock in a corporation, carrying on a trade or business, if (i) 20 percent or more of the voting stock of the corporation is included in determining the gross estate or (ii) such corporation had 10 or less shareholders. In addition, the value (for Federal estate tax purposes) of such stock must exceed either 35 percent of the value of the gross estate of the decedent or 50 percent of the taxable estate. For purposes of this second requirement, stock of two or more corporations, with respect to each of which there is included in determining the value of decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as stock of a single corporation. For the latter purpose, stock which, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property is treated as having been included in determining the value of the gross estate.

Your committee has also amended section 663(a) by renumbering paragraph (3) of the House bill as paragraph (5) and by adding a new paragraph (3) to make it clear that any amount which is properly paid during a period of 36 months from the corpus of a decedent's estate in full or partial satisfaction of a statutory award or allowance for the support of the surviving spouse or dependents, for a limited period during the administration of the estate, is to be excluded from the operation of the tier system.

Your committee has also added a new paragraph (4) to sec. 163(a) which broadens the operation of the exclusionary provisions with respect to distributions by certain small estates. There was no comparable provision in the House bill. Under the amendment, if the value of the gross estate is $100,000 or less, any amount which is properly distributed from the corpus of the decedent's estate within 36 months after the date of death will not be taxable to the beneficiary by reason of section 662, and, of course, will not be deductible by the estate under section 661. For this purpose the "gross estate" is defined to mean the gross estate for Federal estate tax purposes, except that there is not to be included in such computation the value of any property which is includible only by reason of section 2035 (relating to transactions in contemplation of death), section 2036 (relating to transfers with retained life estate), section 2037 (relating to transfers taking effect at death), section 2038 (relating to revocable transfers), section 2039 (relating to annuities), section 2040 (relating to joint interests), section 2041 (relating to powers of appointment), or section 2042(2) (relating to proceeds of life insurance receivable by other beneficiaries). For purposes of this provision a payment shall be deemed to have been made from corpus to the extent it is properly charged against corpus and designated as a distribution of corpus on the books and records of the estate by the fiduciary.

(iii) *Denial of double deduction.*—Section 108(a) of the House bill also amends section 663(a)(3) (redisignated as par. (5) under your committee's bill) to broaden its application so as to prevent a deduction under section 661 for an amount distributed to a charitable beneficiary in a future year, for which a deduction was allowed under section 642(c) in a prior year as an amount permanently set aside for a charitable beneficiary.

(2) Separate share rule (sec. 663(c))

Section 663(c) of present law provides that in the case of trusts having more than one beneficiary, if such beneficiaries have "substantially separate and independent shares," such shares shall be treated as separate trusts for the purpose of determining the amount of distributable net income taxable to the respective beneficiaries under sections 661 and 662. Since the rule does not apply to estates, distributions to residuary legatees who are only entitled to receive corpus may be taxed as distributions of income.

Section 108(b)(1) of the House bill and your committee's bill amends section 663(c) to extend the application of the separate share rule to estates and simple trusts. Your committee believes that this will eliminate many of the inequities under present law whereby beneficiaries receiving distributions from estates are sometimes subjected to taxation on amounts in excess of the share of estate income to which they are entitled.

(3) Required distribution to another trust (sec. 663(d))

Your committee's bill, like the House bill, amends section 663 by adding a new subsection (d) to provide for allocation of items of income and deduction where a new trust is created out of the assets of an existing trust or trusts in order, for example, to provide for afterborn children. This amendment is complementary to the amendments to section 665(b)(6) and (e), contained in section 110(c) of the bill.

Section 664. Power in person other than grantor to vest corpus or income in himself (sec. 109 of bill)

Section 678 provides that a person other than the grantor shall be treated as the owner of any portion of a trust over which he has a power exercisable solely by himself to vest corpus or income in himself. In certain situations where a person other than the grantor has a power to withdraw a limited amount of corpus each year and no withdrawal is made, present law is not clear as to the tax consequences. Likewise, there is doubt under present law as to the extent to which a person with such a power is taxable on capital gains realized by the trust, and what the tax consequences are where a trust provides that a person other than the grantor may withdraw the income of the previous year 1 day after the end of the taxable year.

Your committee believes that a holder of such powers should be treated generally as a beneficiary under the tier system, rather than as an owner under subpart E. Section 109 of your committee's bill, like the House bill, repeals present section 678 and adds a new section 664 to provide for such treatment.

Under section 664(a) of the House bill, if a person, other than the grantor, has a power *exercisable solely by himself* to vest an amount of corpus or income in himself the amount of income or corpus subject to the power (including the amount of income attributable to the corpus) is considered a distribution under section 651 or 661 (regardless of whether or not the power is exercised) and may be taxable to the holder of the power. Under the bill, as amended by your committee, the provisions of section 664 will apply if a person other than the grantor has a power *exercisable by himself alone or by himself and one or more related or subordinate parties* to vest an amount of corpus or income in himself. For example, if a grantor establishes a trust for the benefit of his grandchild and gives his son a power to vest the corpus or income in himself, but only with the approval of the son's wife, the fact that the power is exercisable only with the approval of the wife will not prevent the provisions of section 664 from applying (provided that the wife's approval would not adversely affect a substantial beneficial interest which she may have in the trust). This section does not apply if the power is disclaimed or renounced within a reasonable time after the holder learns of its existence. However, if dominion and control is retained, he may be subject to subpart E even though the power has been partially released or modified.

Section 665. Definitions relating to treatment of excess distributions by trusts (sec. 110 of bill)

(1) Definitions applicable to subpart D (the throwback rules) (sec. 665)

The throwback rules (secs. 665–668), in general, provide that in any year in which a trust distributes amounts in excess of its distributable net income for the current year, such excess is "thrown back" and treated as having been distributed in the most recent of the last 5 preceding years, and is taxed to the beneficiaries to the extent that distributable net income for any of the 5 prior years was accumulated. The amounts which would have been includible in gross income by the beneficiary in the back years if actual distributions had been made are includible in the income of the beneficiary for the current taxable year, but the tax thereon may not exceed the aggregate of the taxes that would have been payable if the distributions had been made in the prior years. A refund is denied the trust and a credit is allowed the beneficiary for the amount of taxes paid by the trust for the prior years.

Section 110(a) of the bill conforms section 665(a) to the proposed changes in the tier system and in the treatment of charitable contributions.

Section 665(b) makes the throwback provisions inapplicable unless the accumulation distribution of the current year exceeds $2,000. Moreover, the definition of "accumulation distribution" excludes from the operation of the throwback rules the following amounts:

(1) Amounts properly paid or credited to a beneficiary to meet his emergency needs;

(2) Amounts paid or credited as income accumulated for a minor;

(3) Amounts required by the terms of a trust, created before January 2, 1954, to be paid to a beneficiary upon attaining a specified age or ages, provided there are not more than four such distributions and at least 4 years separate each distribution;

(4) Amounts paid as a final distribution of a trust if the last transfer to the trust was made more than 9 years before.

Section 110(b) of the bill makes the exception in section 665(b)(3) applicable where, under the terms of the trust instrument, a distribution to a beneficiary is payable upon a specified date or dates as well as upon such beneficiary's attaining a specified age or ages, provided the other conditions prescribed in the exception are met.

The purpose of the 9-year exception in section 665(b)(4) was to exclude final distributions of a trust from the throwback rules without, however, at the same time encouraging the creation of trusts for the purpose of accumulating income and making final distributions within unreasonably short periods. Interpreted literally, a final distribution in 1958 of accumulated income from $100,000 of corpus originally transferred to a trust 25 years ago would subject the entire distribution to the throwback rules if $100 had been added to the trust in 1956. Thus, a small gift from the grantor or any other person might cause the throwback rules to apply.

Your committee believes that this inequity can be corrected without undermining the basic objective of the present exception. Accordingly, section 110(b) of your committee's bill also amends section 665(b)(4) so that the throwback rule will apply only to the extent the final distribution is attributable to property transferred to the trust within the 9 years preceding such distribution, including the income attributable to such property.

Section 110(a) of the House bill conformed section 665(a) to the proposed changes in the tier system and in the treatment of charitable contributions. Your committee's bill modifies section 110(a) of the House bill. Under the House bill, charitable deductions specified in section 661(a)(4) (after reduction by any amount disallowed under section 681) reduced the amount of undistributed net income for purposes of the throwback rules of section 665. As indicated in the discussion under section 661, as proposed to be amended by section 106 of the bill, your committee's bill allows amounts paid for one or more of the purposes specified in section 170(c) as a deduction under section 661(a)(3) (rather than under section 661(a)(4)) and has modified section 661(a)(4) in a number of respects. As indicated in that discussion, your committee's bill limits the deduction under section 661(a)(4), as proposed by the House bill, to amounts of gross income for the taxable year which are permanently set aside for one or more of the purposes described in section 170(c) or to be used exclusively for religious, charitable, scientific, etc., purposes.

Your committee does not believe that it is appropriate to reduce undistributed net income for purposes of the throwback rules of section 665 by the amounts described in section 661(a)(4), as proposed to be amended by your committee's bill. Although such amounts of gross income for the taxable year may constitute deductions, subject to the limitations of section 661, in determining taxable income of a trust or estate for such year such amounts will nevertheless not be allowed to reduce undistributed net income of that year for purposes of the throwback rules of section 665. Your committee believes that such an amendment is necessary to carry out the objective in placing such amounts in effect in a fourth tier of section 662 (via the exclusion of such amounts from the first three tiers of section 662) to prevent such amounts from reducing the amount of the distributable net income taxable to beneficiaries of amounts specified in any of the preceding three tiers of section 662(a). Without such an amendment to section 665 by your committee's bill, the described policy of section 662 could be thwarted by currently reducing or eliminating undistributed net income by the amounts permanently set aside or to be used for charitable purposes and merely delaying to a later year the distribution of amounts to noncharitable beneficiaries.

Section 110(b) of the House bill also added two new exceptions (pars. (5) and (6)) to the throwback rules in section 665(b). Paragraph (5) of section 665(b), as proposed to be amended by the House bill, excepts from the operation of the throwback rules certain amounts paid as a final distribution of a trust upon a beneficiary attaining a specified age if such trust was created by will or was revocable by the grantor immediately before his death. Your committee believes that such an exception would further undermine the objective of the throwback rules and has deleted it from the bill.

Paragraph (6) of section 665(b), as added by the House bill which has been renumbered as paragraph (5) by your committee's bill, excludes from the throwback rules certain amounts required to be paid or distributed to another trust. It is designed to avoid application of the throwback rules where a grantor provides for the creation of additional trusts out of the assets of an existing trust in order, for example, to make provision for afterborn children.

Your committee has added in subsection (c) of section 110 of its bill the amendment to section 665(c) (relating to taxes imposed on the trust) that would have been made by section 113(b)(1) of the House bill (relating to multiple trusts). Your committee, however, has deleted from the amendment to section 665(c) proposed in section 113(b)(1) of the House bill the reference to multiple trust distributions since your committee's bill deletes the multiple trust provisions of section 113 of the House bill. (See discussion under sec. 101 of your committee's bill.)

Section 110(c) of the House bill adds a new subsection (e) to section 665 to provide rules for determining the portion of the distributing trust's undistributed net income (under sec. 665(a)) and the taxes imposed on the trust (under sec. 665(c)) which are to be attributed to the receiving trust under new section 665(b)(6), as proposed to be amended by the House bill. Your committee's bill retains this amendment in section 110(d) of its bill.

(2) *Foreign trusts*

Your committee has added a new sentence at the end of section 665(b) and new subsections (f) and (g) to section 665 in order to prevent the avoidance of U.S. tax with respect to distributions received by U.S. citizens and residents from foreign trusts. There was no comparable provision in the House bill.

The problem arises from the establishment of trusts by a U.S. grantor or settlor in a foreign country to accumulate the income and, on termination, to distribute the corpus and accumulated income to a U.S. beneficiary. The income derived by the trust (including dividends and capital gains derived from investments in other foreign countries) can be accumulated free of any U.S. tax. Because of the exceptions to the throwback rules provided by section 665(b) (e.g., accumulation during minority or the 9-year rule), when the trust terminates and distributes the corpus and accumulated income to a U.S. citizen or resident, such distribution may entirely escape U.S. tax.

In order to discourage the creation of such foreign trusts for the purpose of avoiding U.S. tax, your committee has amended section 665(b) to deal with this problem. Under new subsection (f) a foreign trust is defined as one created by a citizen or resident of the United States which is subject to tax under chapter 1 only pursuant to the provisions of section 871, or would, if it had income from sources within the United States, be subject to tax under such provisions.

Under the amendment the $2,000 limitation specified in section 665(b) and the exceptions to the throwback rule specified in paragraphs (1) through (5) thereof are made inapplicable to distributions by foreign trusts to U.S. citizens or residents to the extent such distributions are deemed to consist of income from foreign sources or net capital gains from the sale or exchange of capital assets which are not subject to U.S. tax under section 871. Capital gains of a trust which is a nonresident alien described in section 871(c) and which are subject to tax under chapter 1 will not, of course, be regarded as gains from the sale or exchange of capital assets "which were not subject to tax under section 871." The term "not subject to tax under section 871" also, of course, does not include capital gains which were subject to the provisions of section 871 but were not taxable by reason of deductions or exemptions. Such capital gains are to be regarded as "subject to tax under section 871" even though no tax was in fact payable. Hence, the amounts distributed in excess of the distributable net income of the current year would be considered an accumulation distribution subject to the operation of the 5-year throwback rule in the hands of the beneficiary, and the distributions would be taxed to the extent income was accumulated by the trust in the preceding 5 years prior to the distribution. To the extent that distributions consist of ordinary income from sources within the United States, the existing provisions of section 665(b) (including the limitation and exceptions) would continue to apply.

The new subsection (g) provides that net capital gains which are not subject to U.S. tax under section 871 will be included in distributable net income, without regard to section 643(a)(3), for purposes of computing the undistributed net income under section 665(a).

In other respects, the rules of existing law will continue to apply to distributions of foreign trusts. For example, the credit for taxes paid by the trust will be available to the beneficiary under section 668(b), and the beneficiary will be entitled to a foreign tax credit for his share of the foreign income taxes paid by the trust.

Section 666. Accumulation distribution allocated to 5 preceding years (sec. 111 of bill)

Section 111 of your committee's bill makes a technical conforming amendment to section 666 to reflect the proposed changes in the tier system. Section 113(b)(2) of the House bill made certain amendments to section 666 which also appear in section 111 of your committee's bill. This amendment strikes out the last sentence of subsections (a), (b), and (c) of section 666 and adds a subsection (d) to section 666 containing the same substantive rules.

Section 667. Denial of refund to trust (sec. 112 of bill)

Section 113(b)(3) of the House bill amended section 667 to conform the revision of section 668(b) made by section 113 of your committee's bill.

Section 668. Treatment of amounts deemed distributed in preceding years (sec. 113 of bill)

Section 112 of the House bill has been renumbered as section 113 of your committee's bill. It revises section 668(a) in order to conform this section with the proposed changes in the tier system. In addition, the amendment made by section 113(b)(4) of the House bill, amending section 668(b) to provide that the beneficiary will receive a credit against his tax in an amount equal to the taxes deemed distributed to him under section 668 (b) or (c), is made by section 113(b) of your committee's bill.

Section 671. Trust income deductions and credits attributable to grantors as substantial owners (sec. 114 of bill)

Sections 671–677 of present law (commonly referred to as the Clifford trust rules) not only treat grantors as the owners of all or a part of the trust property where they retain substantial dominion and control over the property transferred to a trust, but also tax them on the income therefrom. Section 678 taxes persons other than the grantor as the owner of any portion of the trust property over which they have a power exercisable solely by themselves to vest corpus or income in themselves.

Section 671 states the general rule that where the grantor or another person is regarded as the owner of any portion of a trust there shall be included in computing the taxable income and credits of the grantor, or such other person, those items of income, deductions and credits against tax of the trust which are attributable to that portion of the trust, as if the person deemed to be the owner of such portion of the trust were an individual.

Section 114 of your committee's bill deletes the references to "other persons" in section 671 in order to conform the section with the amendment in section 109 of the bill which removes section 678 from this subpart. The amendment also strikes from section 671 the words "an individual" and substitutes in lieu thereof "the grantor" in order to eliminate any doubt as to the proper computation of the tax where a corporation, for example, is the grantor of a trust. This is intended to be declaratory of existing law.

Section 674. Power to control beneficial enjoyment (sec. 115 of bill)

Section 674(a) establishes the general rule that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party.

(1) Power exercisable by will or by deed (sec. 674(b)(3))

Under section 674(b)(3) a power in any person exercisable only by will, to control beneficial enjoyment of the income which is exercisable only by will, is, generally speaking, excepted from the operation of section 674(a).

Section 115 of your committee's bill extends the exception in section 674(b)(3) to a power to appoint by deed, as well as a power to appoint by will, where the exercise of the power to appoint by deed cannot confer beneficial enjoyment of the trust property on anyone until after the death of the holder of the power.

The last sentence of the amended paragraph (3) of section 674(b) makes it clear that such paragraph does not apply to a power which does not exclude the grantor and his estate as possible appointees; the House bill referred in this connection only to a power exercisable by deed.

(2) Power to distribute corpus (sec. 674(b)(5))

Section 674(b)(5) excepts from the general rule of section 674(a) a power to distribute corpus to a class of beneficiaries under certain prescribed conditions.

The last sentence of section 674(b)(5) provides that such a power will not be excepted from the general rule, if any person has a "power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, unless such action is to provide for afterborn or afteradopted children." This latter provision is known as the "exception to the exception," and where applicable, renders inoperative the exception to the general rule provided in paragraph (b)(5). This identical clause also appears in sections 674(b)(6), 674(b)(7), 674(c), and 674(d), and where applicable destroys the exceptions provided in those paragraphs and subsections.

Section 115(b) of the House bill amends the last sentence of section 674(b)(5) relating to the exception to the exception to:

(a) make it clear that it does not apply where the person having the power to add to the beneficiaries is an adverse party as defined under section 672(a);

(b) make it clear that it does not apply to a power which qualifies under proposed section 674(b)(3);

(c) make the clause inapplicable where a power to add beneficiaries provides for adding an "after-acquired spouse," as well as "afterborn or afteradopted children"; and

(d) substitute the word "change" for the word "add" in the statutory language.

The bill as amended by your committee modifies the House bill so as to eliminate the two changes made by the House described in clauses (a) and (b) in the preceding paragraph. In other words, your committee has eliminated so much of the amendments made by the House bill to the "exception to the exception" clauses as would make such clause inapplicable to powers held by an adverse party and to powers qualifying under section 674(b)(3). Your committee believes that the House amendments are unnecessary.

(3) Power to withhold income temporarily (sec. 674(b)(6))

Section 674(b)(6) provides another exception to the general rule of section 674(a) with respect to a power in the trustee to withhold income from a current income beneficiary if ultimately the accumulated income must go to such beneficiary, his estate, or his appointee or alternate takers in default of appointment, provided that—

> *such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate,* * * *.

It has been pointed out that if the grantor were excluded from this group of possible appointees the exception would not be operative and the grantor, who could not take, would be taxable.

Section 115(c) of the House bill amended section 674(b)(6) for the stated purpose of clarifying the language and closing what it regarded as a possible loophole in present law by requiring that the grantor and his estate be excluded from the class of possible appointees. Under the House bill, this amendment would become effective 1 year after date of enactment of the bill in order to give the donee of the power time to exclude the grantor and his estate as possible appointees. Section 115(c) of the House bill also amended the last sentence in section 674(b)(6), relating to the "exception to the exception" clause as discussed in the amendment to section 674(b)(5).

Your committee has amended the bill so as to modify the amendment which the House bill made with respect to exclusion of the grantor and his estate as possible appointees. Although your committee agrees that the grantor and his estate should not be required to be included as possible appointees in order for a power to qualify under section 674(b)(6), it believes that this problem can be met by simply eliminating the requirement that the grantor and his estate be included as possible appointees and believes that it is not necessary, and may only raise still further technical problems, to require that the grantor and his estate be excluded as possible appointees. Your committee believes that the question of whether the fact that the grantor or his estate are possible appointees under a power described in section 674(b)(6) should cause the grantor to be treated as owner of the trust should be resolved under provisions of subpart E other than section 674.

Section 1.674(b)–1(6) of existing regulations provides that where a power described in section 1.674(b)–1(6)(a) exists which meets the requirements of section 674(b)(6), the existence of the power will not subject the grantor to tax under section 677. Under the change effected by your committee's bill it will be possible to exclude the grantor and his estate as objects of a power qualifying under section 674(b)(6). This will eliminate the problem which would arise under existing law with respect to section 677, and, therefore, the regulatory provision will no longer be necessary.

Your committee's bill also revises the amendments made to the "exception to the exception" clauses as discussed in connection with the amendment to section 674(b)(5).

Your committee's bill also revises the effective date provisions contained in section 115(c)(2) of the House bill. Although section 115(c)(2) of the House bill was intended to prescribe a special effective date of 1 year after the date of enactment only with respect to so much of the amendments made by section 115(c)(1) as amended the requirement that the grantor and his estate be included as possible appointees, the effective date provisions inadvertently apply to all amendments made by section 115(c)(1) of the bill. Your committee has amended section 115(c)(2) so as to limit the special effective date provision to so much of the amendments made by section 115(c)(1) as would eliminate the requirement that the grantor and his estate be included as possible appointees.

(4) Power to withhold income during disability of a beneficiary (sec. 674(b)(7))

Section 115(d) of the House bill amended the last sentence in section 674(b)(7) relating to the "exception to the exception" clause. Your committee's bill revises this amendment as discussed in the amendment to section 674(b)(5).

(5) Exception for certain powers of independent trustees (sec. 674(c))

Section 674(c) excepts from the general rule stated in section 674(a) a power exercisable solely by a trustee or trustees other than the grantor, no more than half of whom are related or parties subservient to the grantor, to (1) distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries, or (2) to pay out corpus to a beneficiary or a class of beneficiaries.

Under present law if the described powers are vested in three trustees, only one of whom is independent, even though unanimous consent is essential to the exercise of the power the exception would be inoperative and the grantor would be treated as the owner of the trust income.

Section 115(e) of the House bill and your committee's bill amends section 674(c) to extend the exception to a situation where the described powers are vested in cotrustees and one is independent. For example, where the described powers are vested in three trustees, one of whom is an independent trustee, if the unanimous consent of all trustees is essential to the exercise of the power, it will qualify under section 674(c). Section 115(e) of the House bill also amended the last sentence in section 674(c) relating to the "exception to the exception" clause. Your committee's bill revises the amendment as discussed in the amendment to section 674(b)(5).

(6) Power to allocate income if limited by a standard (sec. 674(d))

Section 674(d) excepts from the operation of the general rule in section 674(a) a power, exercisable by a trustee or trustees, "none of whom is the grantor" or his spouse, to accumulate or distribute income to a beneficiary or class of beneficiaries, if limited by a standard, even though the power is exercisable by related or subservient trustees.

Section 115(f) of your committee's bill amends section 674(d) by striking the words "none of whom is the grantor" and substituting the words "other than the grantor" in order to conform the language in section 674(d) to the changes in section 674(c). Section 115(f) of the House bill also amends the last sentence in section 674(d) relating to the "exception to the exception" clause. Your committee's bill revises the amendment as discussed in the amendment to section 674(b)(5).

Section 675. Administrative powers (sec. 116 of bill)

Section 116 of your committee's bill contains a technical amendment to section 675 which adds the words "acting alone" in the parenthetical clause. It is intended to make clear that trust income will not be taxable to the grantor where the trust instrument contains a general lending power to make loans without regard to interest or security in situations where the grantor is only one of several trustees.

Section 677. Income for benefit of grantor (sec. 117 of bill)

(1) Obligation of support (sec. 677(b))

Section 117(a) of the bill is a conforming amendment to section 677(b) which deletes the references to paragraph (2) of section 661(a) and substitutes references to paragraph (3) of section 661(a).

(2) Existence of discretion as to income (sec. 677(c))

Under section 677(a) the grantor is treated as the owner of any portion of a trust whose income "in the discretion of the grantor or nonadverse party" may be distributed or accumulated for the benefit of the grantor or used to pay premiums upon policies of insurance on his life. Present law is not clear as to the extent to which it applies to a trust in which the trustee has discretion to distribute or accumulate income, but the grantor reserves a power to withdraw a limited amount of corpus in each year.

Section 117(b) of the House bill and your committee's bill adds a new subsection (c) to section 677 which provides that discretion (referred to in sec. 677(a)) exists to distribute income to the grantor or to apply income for the support of a beneficiary whom he is legally obligated to support or to apply income to the payment of premiums on policies of life insurance, even though the terms of the trust specify that the discretion relates only to corpus, to the extent that the income of the trust is not required to be distributed currently. Thus, where a grantor reserves a power to withdraw corpus, but gives the trustee discretion to distribute or accumulate the income for the benefit of another, the amendment makes it clear that the grantor will be taxed on the full amount of the trust income to the extent it was not required to be distributed currently.

Section 681. Limitation on charitable deduction (sec. 118 of bill)

The amendments to section 681 (a), (b), and (c) are largely conforming amendments to implement the proposed change in the treatment of charitable contributions. The amendments correct technical defects in section 681 (b) and (c) with respect to the 30 percent limitation where the beneficiary is a church, educational organization, or a hospital.

Section 119 of bill. Conforming and technical amendments

Section 119 of your committee's bill amends various provisions of the code to conform them to the bill. It also amends section 6501 to provide a 6-year statute of limitations with respect to certain trusts taxable under section 641(c) (relating to multiple trusts).

Section 120 of bill. Clerical amendments

Section 120 of your committee's bill makes clerical amendments.

Section 121 of bill. Effective date

Section 121 provides a general effective date for the amendments made by title I of the bill.

IV. TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

Short title

Section 1(a) of your committee's bill corresponds to section 1(a) of the House bill and provides that the act may be cited as the "Trust and Partnership Income Tax Revision Act of 1960."

Amendment of 1954 code

Section 1(b) of your committee's bill corresponds to section 1(b) of the House bill and provides that whenever in the bill an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

A. TECHNICAL EXPLANATION OF TITLE I—ESTATES AND TRUSTS

SECTION 101. IMPOSITION OF TAX—AMENDMENTS OF SECTION 641

Section 641(c). Terminable legal interests

Subsection (a) of section 101 of the House bill added a new section 641(c), to deal with problems encountered with respect to legal life estates, etc. Your committee's bill deletes this provision.

Section 641(a)(2). Income collected by guardian

Income collected by a guardian of an infant is not taxable under subchapter J. The tax falls on the infant. The deletion in section 641(a)(2) of the material referring to the guardian of an infant makes no change in the substantive application of the section but eliminates a latent ambiguity in the code. Section 101(a) of your committee's bill corresponds to this provision of the House bill. This change does not affect the return requirements of subtitle F. With respect to income of this kind, the return is, in general, filed by the guardian.

Section 641(c). Multiple trusts

Section 113(a) of the House bill added a new section 669, dealing with distributions by multiple trusts, which is deleted in your committee's bill.

Section 101(b) of your committee's bill adds a new subsection 641(c) to deal with multiple trusts, approaching the problem by imposing an additional tax at the trust level currently in lieu of imposing a tax at the beneficiary level at the time of a distribution as was done by the approach taken in the House bill.

Section 641(c) deals separately with inter vivos and testamentary trusts. In the case of inter vivos trusts, if a grantor establishes at any time two or more separate inter vivos trusts, then to the extent that during any year or portion of a year the primary beneficiary or beneficiaries of the currently accumulated income or taxable income allocated to corpus of the separate trusts are substantially the same, the total tax payable for such year or portion by the separate trusts on such income or such taxable income or both shall be computed as though the separate trusts were one trust with respect to such taxable income. In making such a computation, no account shall be taken of the excess of deductions over gross income or the net capital losses of any one separate trust. The subsection will not apply when the combined total of currently accumulated income or taxable income allocated to corpus of the separate trusts, or both, is less than $2,000. Similar rules prevail in the case of two or more testamentary trusts created by the same testator; however, as indicated above, inter vivos separate trusts are not to be joined with testamentary trusts. The section will not apply in the case of inter vivos trusts if such trusts do not exceed two in number and were not created within a period of 96 months.

If two trusts are created 96 months apart, they will be subject to the operation of section 641(c) if a third trust, the primary beneficiary or beneficiaries of which are substantially the same, is created, either within the 96-month period or subsequently. This would be true even if, for example, because of losses, there was no currently accumulated income or taxable income allocated to corpus in the third trust for the taxable year involved. Thus, a third trust could cause section 641(c) to require the aggregation of amounts received by two other trusts, although none of its own income were taken into account in the aggregation.

The term "currently accumulated income" as used in the new section means income received or accrued during the taxable year of a trust which under the terms of the governing instrument or local law has been properly accumulated. The term "taxable income" allocated to corpus would ordinarily include such items as capital gains, taxable stock dividends, and extraordinary dividends.

Section 641(c) provides that the Secretary or his delegate shall prescribe by regulations the method of computing the total tax payable by the separate trusts and may require that the income of the separate trusts be computed and reported in accordance with the same method of accounting or on the basis of the same taxable year or both. The Secretary or his delegate may also prescribe by regulations the method of allocating and assessing the total tax among the several trusts. No consolidated return for the multiple trusts will be required, but each trustee will compute the additional taxes payable by his trust pursuant to such regulations as may be prescribed.

It should be noted that the separate trusts retain their separate identity for the purposes of determining the distribution deductions available to each and the undistributed net income which each will have in applying the throwback rule. The taxes imposed on each trust for the purpose of section 665(c) are the taxes allocated and assessed to each trust pursuant to regulations prescribed by the Secretary or his delegate.

For purposes of the new subsection, the term "inter vivos trusts," during the lifetime of the grantor, means any trusts established by him, and after the death of the grantor, means any trusts established by him during his lifetime where the terms of his will do not specify an augmentation thereof. A "testamentary trust" is defined to mean any trust established by will including any augmentation by the testator pursuant to the terms of an inter vivos trust or otherwise and any trust established by the testator during his lifetime where the terms of his will specified an augmentation thereof.

A revocable inter vivos trust shall continue to be classified as an inter vivos trust when the power of revocation ceases to exist by reason of the death of the grantor. If, however, the grantor pours over to an inter vivos trust from his will, the augmented inter vivos trust shall be deemed established by the grantor's will and thus shall be treated as a testamentary trust, even though under State law an augmented inter vivos trust may not be regarded to any extent as a testamentary trust.

Section 641(c)(3) provides for a special tax rate with respect to long-term capital gains in computing the tax under section 641(c). Under paragraph (3) the excess of such long-term gain over the net short-term loss will be subject to a flat 25-percent rate. The deduction provisions of section 1202 and the alternative tax provisions of section 1201(b) would therefore not apply, since the flat rate of tax applies notwithstanding any provision of the code other than paragraph (3).

In computing the tax on the capital gains of several trusts under section 641(c) (1) or (2), it should be noted that paragraphs (1) and

(2) provide that the net capital loss of a separate trust is not to be taken into account.

The words "primary beneficiary or beneficiaries" are defined as the beneficiary or beneficiaries to whom the accumulated income or taxable income allocated to corpus would first be distributed where there is an order of succession with respect to such income or such taxable income. Whether separate trusts which have been established by a grantor or testator have "substantially the same" primary beneficiaries depends on the entire beneficiary pattern presented by the separate trusts.

If the terms of a trust call for the distribution in the future of accumulated income to the children of a designated person and, if there are no children, to someone else, such children may be the primary beneficiaries, even though in the year in question no child has been born to the designated person. If the trustee has discretion to pay the income to a designated beneficiary or accumulate the same, the primary beneficiary of the accumulated income is not the person to whom it could have been paid in the first instance unless the trustee has the power to pay such person accumulated income as well as current income.

Generally, the possible appointees under a power of appointment other than such a general power shall be considered to be the primary beneficiaries of currently accumulated income or taxable income allocated to corpus subject to such power. However, when a primary beneficiary of the currently accumulated income has a power the exercise of which will adversely affect his chance of receiving such income, the objects of the power shall not be deemed primary beneficiaries of such income in determining whether the primary beneficiaries of currently accumulated income under several trusts are substantially the same. Where a person has a power in a subsequent taxable year to pay the currently accumulated income to himself, whether he has such power alone or in conjunction with another who does not have a substantial adverse interest, the holder of the power shall be deemed the primary beneficiary in making such determination. When the primary beneficiary of currently accumulated income or taxable income allocated to corpus, or both, is the estate of the holder of the power and the primary beneficiaries of such income or such taxable income, or both, of another trust are the possible appointees under a power, the primary beneficiaries of the two trusts are not substantially the same.

The fact that the separate trusts have different termination dates or different distributees of corpus (as distinguished from accumulated income) on termination will not necessarily prevent them from being taxed as one trust where the primary beneficiaries of currently accumulated income or taxable income allocated to corpus are substantially the same. If, however, as events occur, such primary beneficiaries change so that they are no longer substantially the same, for example, where the original primary beneficiaries die, then the separate trusts will be separate tax entities from that time on. If, as events occur, the primary beneficiaries change so that they become substantially the same, then the separate trusts will be taxed as one from that time on.

The primary beneficiaries of the currently accumulated income or the taxable income allocated to corpus will be the persons to whom the trustee in his discretion may distribute such income from time to time when the trust is one giving the trustee such discretion. The fact that the persons to whom the trustee may distribute such income under several different trusts differ in some respects will not prevent the primary beneficiaries under the several trusts from being substantially the same where the entire beneficiary pattern of the several trusts makes it apparent that substantially the same beneficiaries will receive benefits under the several trusts. Where a beneficiary is a member of a group of primary beneficiaries of a trust, he may also be treated as a primary beneficiary for purposes of determining whether that trust and another trust of which he is the only beneficiary are to be treated as multiple trusts.

Set out below are several examples indicating when the primary beneficiaries of trusts are to be considered substantially the same.

Example 1.—A establishes trust 1 to last for 9 years and 1 day. During the period of the trust the income is to be paid to S or accumulated, in the discretion of the trustee. On the termination of the trust the principal and accumulated income are to be paid to S or his estate. On the following day, A establishes trust 2 which is identical with trust 1 except that the termination date is 10 years and 1 day after its creation. The primary beneficiary of the currently accumulated income and of the taxable income allocated to corpus of the two inter vivos trusts is the same and hence the total tax payable by the two trusts is determined by treating the two trusts as one.

Example 2.—T in his will gives the residue of his estate to a trustee and directs the trustee to divide the residue into as many equal shares as there are children of T who survive him and children of T who predecease him leaving issue who survive him. One of such equal shares is to be allocated to each living child of T and each share so allocated is to be held in a separate trust in accordance with a designated provision in T's will. One of such equal shares is to be allocated to the issue of each deceased child of T and each share so allocated is to be held in a separate trust in accordance with a designated provision in T's will. The trustee is given discretion to pay out the current income of the separate trust for each living child of T to any one or more of the group consisting of such child, such child's issue, and T's wife, or to accumulate it, and is given discretion to pay out to such group any accumulated income. The trustee is given discretion to pay out the current income of the separate trust for the issue of each deceased child of T to any one or more of the group consisting of such deceased child's issue and T's wife, or to accumulate it and is given discretion to pay out to such group any accumulated income. Though T's wife is one of the potential beneficiaries of the currently accumulated income of each of the separate trusts, the primary beneficiaries are not substantially the same in the absence of evidence that his wife is to be preferred over other members of the family group. The separate trusts are established primarily for the different branches of T's descendant line. Thus each separate trust is a separate tax entity. Separate inter vivos trusts of the same type would also be separate tax entities.

Example 3.—In one calendar year A establishes trust 1 for the benefit of his sister S and trust 2 for the benefit of his brother B. The current income of trust 1 is payable to S and of trust 2 to B. On the death of S, the trust property of trust 1 is to be distributed to A's issue then living, such issue to take per stirpes. On the death of B, the trust property of trust 2 is to be distributed to A's issue then living, such issue to take per stirpes. The primary beneficiaries of the taxable income allocated to corpus of the two trusts are substantially the same (the fact that A's issue living at S's death may be different from his issue living at B's death is not sufficient to make the primary beneficiaries of the two trusts other than substantially the same) and hence the total tax payable by the two trusts on such income is determined by treating the two trusts as one.

Example 4.—In one calendar year A establishes trust 1 for the benefit of his sister S1 and brother B1 and brother B2; trust 2 for the benefit of his sister S2 and brother B1 and brother B2; trust 3 for the benefit of S1 and S2 and B1; and trust 4 for the benefit of S1 and S2 and B2. Under each trust instrument the trustee is given discretion to pay out the current income to any one or more of the designated beneficiaries or to accumulate the same, and is given discretion to pay out to the designated beneficiaries any accumulated income. The primary beneficiaries of the currently accumulated income of each of the four trusts are substantially the same and hence the total tax payable by the four trusts on such income is determined by treating them as one.

Example 5.—H in his will divides the residue of his estate into two shares and establishes a trust with respect to one share under which the current income is payable to his wife, W, for her life and, in addition, the trustee is given discretion to pay principal to W; and on W's death, the trust property is to be distributed as she may appoint by her will and in default of appointment, the trust property is to be distributed to H's issue then living, such issue to take per stirpes. H's will establishes a second trust with respect to the other share under which the trustee is given discretion to pay out the current income to any one or more of the group consisting of W and H's issue living from time to time or accumulate the same and is given discretion to pay out principal and accumulated income to any one or more of such group, and on W's death, the trust property is to be distributed to H's issue then living, such issue to take per stirpes. The primary beneficiary of the income allocated to corpus of the first trust is W. The primary beneficiaries of the income allocated to corpus of the second trust are W and H's issue. The primary beneficiaries of the income allocated to corpus of the two trusts are not substantially the same, even though W is a potential beneficiary under each trust, unless there is evidence to establish that W is to be preferred over the issue in the second trust. If the trustee in the second trust had discretion to pay out principal and accumulated income only to W, the primary beneficiary of the income allocated to corpus of the two trusts would be W and hence the total tax payable by the two trusts on such income is determined by treating the two trusts as one.

Example 6.—H in his will divides the residue of his estate into two shares and establishes a trust with respect to one share under which the current income is payable to his wife, W, for her life and on her death, the trust property is to be distributed as she may appoint by her will and in default of appointment, the trust property is to be distributed to H's issue then living, such issue to take per stirpes; and establishes another trust with respect to the other share under which the trustee is given discretion to pay out the current income to W, or accumulate the same, and is given discretion to pay out principal and any accumulated income to W and on W's death, the trust property is to be distributed to H's issue then living, such issue to take per stirpes. The primary beneficiary of the income allocated to corpus of the first trust is the estate of W. The primary beneficiary of the income allocated to corpus of the second trust is W.

It is possible for separate trusts each to have multiple grantors. The operation of section 641(c) in such a situation is illustrated by the following example: A and B establish trust 1, each contributing one-half of the corpus, under which the trustee is given discretion to pay out the current income of the trust to any one or more of the group consisting of A's issue, or to accumulate the same, and is given discretion to pay out to such group the accumulated income. A and C establish trust 2, each contributing one-half of the corpus. The trustee under this trust is also given discretion to pay out the current income to any one or more of the group consisting of A's issue, or to accumulate the same, and is given discretion to pay out to such group the accumulated income. The primary beneficiaries of the currently accumulated income of each trust are the same. However, only one-half of the currently accumulated income of each trust stems from the same grantor. Therefore, only to the extent of one-half of the currently accumulated income of each trust will the two trusts be treated as one under section 641(c).

If A gives property to other members of his family and they each set up trusts with the same primary beneficiaries of the currently accumulated income or taxable income allocated to corpus, A may be deemed to have established the separate trusts set up by the other members of his family so as to invoke the provisions of section 641(c). Whether A will be deemed to have established the various trusts will depend on whether it can be established that A gave the property to the other members of his family with the understanding that each would establish such a trust with it.

The donor of a power of appointment will be deemed the creator of any trust established by the exercise of the power if it can be established that he gave the power to the donee with the understanding that the donee would establish the particular trust created by the exercise of the power; otherwise, the donee of the power will be deemed the creator of any trust established by the exercise of the power. If it is determined that the donor of the power is the creator of a trust established by the exercise of the power, such trust will be deemed one established by the instrument creating the power in determining whether it is an inter vivos trust or a testamentary one.

Section 641(c)(5) would limit the personal liability of a fiduciary of a multiple trust for taxes due because of the operation of section 641(c) to the extent he did not know such taxes were payable. Subparagraphs (A) and (B) supply rules relating to his knowledge in this regard. The exemption of the fiduciary from personal liability, however, applies only to the amount of any additional tax which may be imposed as a result of the application of section 641(c).

Section 641(c)(6) provides that the Secretary or his delegate may require the grantor of two or more trusts, or his personal representative, or the trustee of any trust to furnish such information with respect to such trusts as reasonably appears to the Secretary or his delegate necessary to carry out the purposes of section 641(c). Section 641(c)(6) also provides that the Secretary or his delegate may on his own initiative, or at the request of the fiduciary of a trust shall, furnish to the fiduciary of a trust information obtained with respect to another trust whose income may enter into the computation of tax under section 641(c), to the extent the fiduciary requires such information in order to determine liability for such tax. Such information shall be furnished only if it reasonably appears to the Secretary or his delegate that the provisions of section 641(c) may apply to such trusts.

Subsection (c) of section 102 of your committee's bill amends section 642(d) to deny the net operating loss carryback provided by section 172 to multiple trusts. A cross reference is also added in section 172(b)(2). The amendment to section 642(d) will deny the carryback only with respect to a year for which the provisions of section 641(c) (1) or (2) apply. Accordingly, if a trust which is treated as multiple in 1962 and 1963 sustains a net operating loss in 1964, the loss may be carried to 1961 but not to 1962 and 1963. In such cases the determination whether the trust is to be treated as a multiple trust is made without taking into account any net operating loss carryback. The amount which would subsequently be available as a carryover to 1965, etc., would not be reduced by taxable income of years to which a loss could not be carried back.

SECTION 102. SPECIAL RULES FOR CREDITS AND DEDUCTIONS

Section 642(a)(3). Dividend exclusion

Section 116(a) excludes from gross income certain dividends received by an individual to the extent that the dividends do not exceed $50. Section 641(b) provides that the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in part I of subchapter J. Sections 652(b) and 662(b) provide that amounts which are paid, credited or required to be distributed currently to a beneficiary shall have the same character in the hands of the beneficiary as in the hands of the estate or trust.

Under present law, distributions of dividends by an estate or trust are deemed to consist of a ratable part of the $50 of excluded dividends, so that if, for example, the estate or trust receives $1,000 of dividends and distributes $500 of dividends to beneficiaries, the estate or trust will be entitled to exclude only $25 of the undistributed dividends.

Section 642(a)(3) was amended by the House bill to provide that in determining whether an estate or trust is entitled to the dividend exclusion, any amount of qualifying dividends allocable to a beneficiary under section 652 or 662 shall be allocable first from the qualifying dividends which are not excluded from gross income, i.e., the estate or trust shall be entitled to the $50 dividend exclusion to the extent that the estate or trust retains qualifying dividends. Your committee's bill contains a corresponding amendment, but the amendment made by the House bill has been revised for clarity. For example, if the distributable net income of an estate or trust includes $1,000 of dividends which qualify for the exclusion under 116(a), and the part of such dividends deemed distributed to beneficiaries amounts to $950, so that $50 of such dividends will be deemed not distributed, the estate or trust will be entitled to exclude the entire $50 from gross income. If in such case the amount of qualifying dividends deemed distributed to beneficiaries is $975, the estate or trust will be entitled to exclude the balance of $25 from gross income.

Section 642(c). Charitable deduction

Under existing law, an estate or trust is allowed a deduction for charitable contributions without regard to the percentage limitations applicable to individuals. Since the theory of taxation of estates and trusts is essentially that they are merely conduits through which income flows from its source to the beneficiaries, an estate or trust is also allowed a deduction for distributions to beneficiaries other than charitable organizations. The deduction for charitable contributions is allowed under section 642(c) as a deduction from gross income in computing taxable income. Section 643 provides that "distributable net income" means taxable income with certain adjustments. The concept of "distributable net income" is used to measure the amount for which an estate or trust is allowed a deduction under sections 651 and 661 for distributions to noncharitable beneficiaries, and to measure the amount includible by the beneficiaries in their taxable incomes under sections 652 and 662.

As a consequence of the conduit principle, it is necessary to determine the character of the items of income which are included in distributions by trusts and estates to charitable and noncharitable beneficiaries. For example, it is necessary to determine to what extent a beneficiary is considered to have received tax-exempt income, or dividends subject to the dividends-received credit. The code provides, in general, that the inclusion of particular items of income in a distribution to a noncharitable beneficiary is determined by a ratio of which the numerator is the amount distributed to that beneficiary and the denominator is distributable net income. However, in the case of an estate or trust which has both charitable and noncharitable beneficiaries, a similar allocation must also be made to the charitable beneficiaries. As was indicated above, since a distribution to a charitable beneficiary is treated as a deduction from gross income in arriving at taxable income, which in turn determines distributable net income, allocations to charitable beneficiaries cannot be determined by a ratio of which distributable net income itself is the denominator. Therefore, although under State law a charitable beneficiary is as much a beneficiary as any other beneficiary, the code literally requires two separate rules for the two types of beneficiaries and two separate sets of computations in preparing the income-tax return of the estate or trust. Finally, in order to carry out the allocation of items of income to a distributee which is treated differently from other beneficiaries, a number of complicating adjustments are required in the code.

Title I of the bill amends subchapter J to provide that charitable distributions by trusts and estates be treated as distribution deductions under section 661, rather than as deductions from gross income under section 642.

The amendment to section 642(c) made by subsection (b) of section 102 of your committee's bill is the first of a series of amendments intended to accomplish this purpose. This change corresponds to section 102(b) of the House bill. It substitutes for the charitable deduction now allowed in computing taxable income in section 642(c) a disallowance of any charitable deduction at this point. Such a disallowance is necessary to avoid a double deduction for the same charitable distribution. For example, a trust instrument may direct the distribution of 30 percent of the income to university A, and the accumulation of the balance of the income for eventual distribution to X, an individual. Since section 641(b) provides that, in general, the taxable income of an estate or trust shall be computed in the same manner as that of an individual, a charitable contributions deduction would (but for this amendment) be allowed under section 170 for the contribution to university A, and a distribution deduction would also be allowed for the same amount under section 661.

Section 642(d). Net operating loss deduction

Section 102(c) of your committee's bill amends section 642(d) to deny the carryback of net operating losses to taxable years of trusts to which section 641(c) (relating to multiple trusts) applies. See discussion under section 101(b).

Section 642(e). Deduction for depreciation and depletion

The amendment to section 642(e) made by section 102(d) of your committee's bill corresponds to section 102(c) of the House bill and is intended to be declaratory of existing law and to make it clear that charitable beneficiaries, as well as taxable beneficiaries, are to be taken into account in determining the allocation to beneficiaries of depreciation and depletion allowances. Section 642(e) of the present code states that an estate or trust shall be entited to these deductions to the extent not "allowable" to other beneficiaries under sections 167(g) and 611(b). The word "allowable" may imply that only taxable beneficiaries are to be considered. However, sections 167(g) and 611(b) use the word "apportioned," which does not carry this connotation, and the bill substitutes "apportioned" for "allowable." Apportioned as used in this context means properly apportioned.

Section 642(h). Carryovers on termination

Section 642(h) is amended by section 102(e) of your committee's bill, which corresponds to section 102(d) of the House bill, to extend the deduction carryover provision of section 642(h) to the termination of a single beneficiary's entire interest in an estate or trust having different beneficiaries where such interest represents a separate share as determined under section 663(c). Under the amendment, the trust loses that portion of the net operating loss carryover, capital loss carryover, and other excess deductions allocated to such a beneficiary.

Section 642(i). Deduction for estate tax

Under the amendment made by section 102(f) of your committee's bill, corresponding to section 102(e) of the House bill, an estate or trust is allowed only that portion of the deduction for estate tax on income in respect of a decedent which is properly attributable to so much of such income as is taxable to the estate or trust. The remaining portion of the deduction will be allowable to the beneficiary to whom the remaining income in respect of a decedent is allocable.

SECTION 103. DEFINITIONS

Section 643(a)(2). Deduction for estate tax

The amendment made by section 103(a) of your committee's bill corresponds to section 103(a) of the House bill and makes it clear that in computing distributable net income the deduction under section 691(c) for estate tax attributable to income in respect of a decedent is not allowed. Such deduction is allowed to the persons taxable upon the income in respect of a decedent to which it is allocable (see the discussion under sec. 642(i)).

Section 643(a)(3)(A). Conforming amendment

Section 103(b) of the House bill changed section 643(a)(3)(A) to conform to changes made by that bill to the tier system under sections 661 and 662. Section 103(b) of your committee's bill revises subparagraph (A) to conform to your committee's revision of the tier system and to conform to the revised treatment of amounts paid, permanently set aside, or to be used for charitable purposes. Your committee's bill amends section 103(b) of the House bill to make it clear that capital losses are excluded in computing distributable net income except to the extent that such losses are utilized in determining the amount of capital gains which are (1) paid, credited, or required to be distributed, or (2) permanently set aside or to be used for charitable purposes.

Section 643(a)(3)(B). When capital gains are paid

Capital gains are included in distributable net income and are taxable to the beneficiaries to the extent that they are paid, credited, or required to be distributed to a beneficiary during the taxable year. This is the rule stated in the present section 643(a)(3) with reference to capital gains which are allocated to corpus. The present statute leaves uncertain whether a distribution of corpus will be deemed to include capital gains realized during the same taxable year. For example, if a fiduciary sells property at a gain and deposits the proceeds in a bank account in which are held funds constituting principal and makes a distribution from that account during the taxable year, it is not clear whether the distribution is to be deemed to include all or a part of the capital gains.

Section 103(b) of your committee's bill, like the House bill, amends section 643(a)(3)(B) to provide that capital gains shall not be considered paid, credited, or required to be distributed (and consequently will be excluded from distributable net income) unless at least one of the following requirements is met:

(1) They are required to be credited or distributed currently under the provisions of the governing instrument or local law.

(2) They are not required to be credited or distributed currently, but the books or other records of the fiduciary or notice to the beneficiary show an intention properly to pay or credit such amounts to the beneficiary during the taxable year.

(3) The fiduciary follows the regular practice of distributing all capital gains.

(4) The capital gains are received in the year of termination of the estate or trust.

(5) The capital gains are received in the year of termination of a separate and independent share (as determined under sec. 663(c)) of the estate or trust, but only to the extent attributable to such separate share.

For example, if an executor sells property for $10,000 realizing a gain of $2,000, and deposits the proceeds of sale in a commingled bank account, and distributes $5,000 from the account to a beneficiary, the distribution will not be considered to include any part of the capital gain if none of the five enumerated requirements is met.

On the other hand, if the fiduciary issues a check on the commingled account for $2,000 payable to a named beneficiary and makes an entry on his books showing that the check is a distribution of capital gain or so notifies the beneficiary, the distribution will be considered a distribution of capital gain.

Under the amendment, where the executor makes a distribution to a beneficiary, he may identify the distribution on his books or records or by notice to the beneficiary as being a distribution of capital gains.

Section 643(a)(3)(C). Corpus deductions

The existing statute allows all items of deductions other than capita losses and the personal exemption, whether paid from income or from principal, primarily as deductions in computing distributable net income, which measures the amounts taxable to income beneficiaries. It is only to the extent that deductions exceed distributable net income that they are allowed by existing law against items of corpus income which are excluded from distributable net income. For example, assume that a distributable trust, having $5,000 of currently distributable ordinary income and $500 of capital gains after taking the deduction under section 1202, pays a trustee's commission chargeable to corpus of $1,000. The $1,000 corpus charge under existing law reduces distributable net income so that the current income beneficiary is taxed on only $4,000. Thus, although the $1,000 corpus charge is paid by the trustee out of the principal of the trust, no deduction is allowed the trustee for such charge and he must report and pay a tax on $500 of capital gain added to principal, less the $300 personal exemption.

Section 103(b) of your committee's bill, as did section 103(b) of the House bill, adds a new subparagraph (C) to section 643(a)(3). This subparagraph treats as corpus deductions all items of deduction which are chargeable to corpus under the provisions of the governing instrument and local law or which are charged to corpus as the result of the exercise of discretion by any person pursuant to the governing instrument. The amendment provides that corpus deductions shall be applied first against income which is excluded from distributable net income, such as capital gains and in certain cases extraordinary dividends and taxable stock dividends. The excess of corpus deductions over excluded income would be allowed, as under the present statute, in computing distributable net income. Capital losses are omitted from the definition of corpus deductions, since they are not taken into account except to the extent of capital gains.

The amendment will prevent the wastage of corpus deductions, but at the same time will not shift the benefit of those deductions to income beneficiaries receiving distributions except to the extent that the deductions exceed corpus income which is excluded from distributable net income. Thus, in the example given above, the trustee would offset the $1,000 of capital gain by $500 (the deduction under sec. 1202), the $300 deduction for personal exemption, and $200 of the corpus charge. The balance ($800) of the $1,000 corpus charge not utilized by the trustee to offset excluded income (capital gain) would then reduce distributable net income, so that the beneficiary would be taxable on $4,200.

Since the deduction for allowable capital losses and the deduction allowed the fiduciary under section 642(b) (deduction for personal exemption) are not taken into account in any event in computing distributable net income, the amendment requires that corpus income excluded from distributable net income be first reduced by these deductions. Your committee's bill also makes it clear that there shall be no reduction in this regard by the corpus deductions themselves or by any deduction for distributions to beneficiaries. The remaining corpus income determines the extent to which other corpus deductions will enter into the computation of distributable net income. Consequently, the benefit of corpus deductions is not passed through to the beneficiaries receiving distributions where corpus income exceeds the corpus deductions. If capital gains allocable to corpus are $1,500, after taking the deduction under section 1202, and the corpus deductions are $1,000, all the deductions would be utilized by the fiduciary and the income beneficiaries would receive no benefit of the corpus deductions.

The definition of corpus deductions does not include deductions chargeable to items of corpus which are distributed to beneficiaries. The result is that if a deductible item chargeable to corpus is properly allocable to an item of corpus which is included in gross income and which is taxable to beneficiaries as part of distributable net income, the beneficiaries to whom such income is taxable will receive the benefit of such deduction. For example, if a trust realizes capital gains and part of the capital gains are distributed currently to beneficiaries, the deductions properly chargeable to the capital gains which are distributed will be allowed in computing distributable net income. If income in respect of a decedent is distributed and therefore taxable to beneficiaries, deductions in respect of a decedent properly allocable to such income will be allowed in computing distributable net income.

Section 643(a)(6). Foreign estates

Section 643(a)(6) of present law provides for the inclusion in distributable net income of items of foreign income of foreign trusts. This inclusion is necessary in the determination of the tax liability of a beneficiary subject to U.S. tax and to prevent distortion of the character rules. A similar rule in the case of foreign income of a foreign estate is provided by the amendment made by section 103(c) of your committee's bill, corresponding to section 103(c) of the House bill.

Section 643(a). Conforming amendment

The deletion of the two sentences at the end of section 643(a) by section 103(d) of your committee's bill, which corresponds to section 103(d) of the House bill, is a conforming amendment in connection with the proposed change in treatment of charitable contributions by estates and trusts.

Section 643(b). Definition of income

The amendment made by section 103(e) of your committee's bill, like section 103(e) of the House bill adds capital gains to the items which are not to be considered income when under the terms of the governing instrument and applicable local law they are allocable to corpus. This change merely clarifies existing law.

Section 643(c). Clerical amendment

The amendment made by section 103(f) of your committee's bill, like section 103(f) of the House bill is a clerical amendment.

Section 643(d). Charitable beneficiary

Section 103(g) of the House bill added a definition of the term "charitable beneficiary." Your committee's bill deletes this change in view of the revision in sections 651, 661, and 662 which refer to amounts paid or permanently set aside for one or more of the purposes described in section 170(c) or to be used for charitable, etc. purposes.

SECTION 104. DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY

Section 651(a). Simple trusts

Under existing law (sec. 651(a)(2)) a trust can be a simple trust only if its terms do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in existing section 642(c) (relating to deduction for charitable, etc., purposes). The amendment made by section 104 of your committee's bill modifies section 651(a) to reflect the treatment of charitable beneficiaries provided by the bill, and makes it clear (in sec. 651(a)(3)) that a trust which satisfies the requirements of new section 651(a) (1) and (2) may be a simple trust if, for the taxable year involved, there is no amount described in the new section 661(a)(4) (relating to amounts paid or permanently set aside for charitable purposes, etc.). The amendment of section 651(a) made by section 104 of your committee's bill corresponds to the amendment by section 104 of the House bill, except for a change made to conform to the elimination of the definition of a charitable beneficiary contained in section 103(g) of the House bill.

Section 651(b). Limitation on deduction

Section 661(c) provides that no distribution deduction is to be allowed to an estate or complex trust in respect of that portion of any distribution which consists of an item of distributable net income not included in the gross income of the estate or trust. Section 651(b), on the other hand, limits the distribution deduction allowed to a simple trust to the lesser of the income required to be distributed currently or the distributable net income, and reduces distributable net income for this purpose by exempt items.

Where distributable net income of a simple trust exceeds the income distribution, distortion may result. If distributable net income was $10,000, but was only $9,000 after excluding exempt income, the trust could receive a deduction of $9,000 for a $9,000 distribution, if section 651 were followed literally, although properly the deduction should be reduced to the extent that the $9,000 actually distributed would be deemed to consist of exempt income, as is provided in section 661(c). Under section 661(c), the deduction ordinarily would be $8,100.

The amendment of section 651(b) made by section 104 of the House bill sought to make it clear that the result under section 651(b) is the same as that arrived at under section 661(c). Section 104 of your committee's bill revises the amendment for clarity. Both distributable net income and income required to be distributed currently must be broken down by character of the items therein, in order to separate out the exempt income and items of deduction allocable thereto. No deduction is then allowed for a distribution to a beneficiary to the extent that the amount otherwise deductible as a distribution deduction is considered to consist of items which are not includible by the trust in its gross income.

SECTION 105. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY

Section 652(b). Clarifying amendment

The insertion in section 652(b) of the words "or applicable local law" by section 105(a) of your committee's bill is not intended to change existing law, but is simply a recognition that local law may specify an allocation of different classes of income to different beneficiaries and that if it does the effect will be the same as if the terms of the trust made such specification. This section corresponds to section 105(a) of the House bill.

Section 652(c). Different taxable years

Under existing law, where a beneficiary of a simple trust and the trust have different taxable years, the tax of the beneficiary is measured by the distributable net income of the trust for the taxable year of the trust ending with or within the taxable year of the beneficiary. The language of existing law, however, is not explicit where, for example, because of the death of the beneficiary, there is no taxable year of the trust ending with or within the beneficiary's last taxable year.

The amendment to section 652(c) made by section 105(b) of the House bill provides for the determination of the amount of income of a trust which is to be included in the final return of a beneficiary. For this purpose, in computing distributable net income with respect to the beneficiary, there shall be taken into account his share of the income of the estate or trust up to the time of termination of the beneficiary's taxable year, reduced by items properly charged against such share. Section 105(b) of your committee's bill adopts this change but designates section 652(c), as revised by the House bill, as paragraph (1) of section 652(c), prescribing a general rule. In addition, your committee's bill adds a new provision, designated as paragraph (2), prescribing a limitation on tax.

The following example illustrates the operation of section 652(c)(1) as amended by section 105(b) of your committee's bill:

A distributable trust and its beneficiary both file returns on the cash receipts and disbursements method and on the basis of the calendar year. The beneficiary died on July 31. During his lifetime the beneficiary was entitled to receive all the income of the trust as computed for trust accounting purposes; i.e., the sum of receipts allocable to income account, less the sum of (A) expenses charged to income account, and (B) a reserve for expenses properly chargeable to income account. Based on the following figures the net amount taken into account for the beneficiary's last taxable year would be $18,447:

	I	II	III
	Items received Jan. 1-July 31	Items received Aug. 1-Dec. 31	Col. II items allocable to decedent's estate
INCOME			
Taxable interest	$4,000	$1,000	$200
Exempt interest	0	800	150
Dividends	10,000	7,000	1,800
Rents	8,000	4,000	0
Capital gains	1,000	6,000	0
Total	23,000	18,800	2,150
EXPENSES	Items paid Jan. 1-July 31	Items paid Aug. 1-Dec. 31	Col. II items chargeable to decedent
Income commissions	0	$836	$503
Principal commissions	0	3,000	0
Attorneys' fees charged to principal	0	5,000	0
Real estate taxes	$1,800	1,800	0
Other real estate expenses	1,200	1,300	50
Total	3,000	11,936	553

The $18,447 amount is computed by subtracting from $22,000 (the sum of the income items in col. I reduced by capital gains of $1,000), $3,000 (the sum of the deductions shown in col. I), and $553 (the sum of the deductions shown in col. III).

The distributable net income which limits the taxability of the amount of income distributable to the beneficiary during his lifetime is to be computed as if the period January 1 through July 31 were a taxable year, except that items of deductions paid after the beneficiary's death, which represent expenses properly chargeable in determining trust income for such period, are to be taken into account (i.e., $553). This is true even though this trust files its return on the cash basis.

The distributable net income properly allocable to the period January 1 through July 31 thus is the same as the income which was currently distributable to the beneficiary for trust accounting purposes. Under the trust instrument, the income ($2,150) accrued on July 31, but not collected, is not properly allocable to the period January 1 through July 31.

The excess of income accrued on July 31, but not collected, over accrued deductions chargeable to income account represents income in respect of a decedent which will be taxable under section 691.

It is possible for a deceased beneficiary to be taxed under both subparagraphs (A) and (B) of paragraph (1) as revised. Thus, if a trust is on a fiscal year ending January 31, 1961, and the beneficiary, previously reporting on a calendar year basis, dies November 30, 1961, the decedent's tax will in part be computed under subparagraph (A) with respect to the fiscal year of the trust ending in 1961, that is, the taxable year of the trust ending within his last taxable year. But subparagraph (B) will apply with respect to the period from January 1 to November 30. The result of the operation of the two subparagraphs is the inclusion of 22 months of trust income in the decedent's last return.

Section 652(c)(2) as added by your committee's bill prescribes a limitation on the tax where, for example, income of a trust for 22 months would otherwise be includible in the decedent's last taxable year. Paragraph (2) provides, if amounts are includible under both subparagraphs (A) and (B) of paragraph (1), that the tax attributable to the amount included under subparagraph (B) shall not be greater than the aggregate of the taxes attributable to such amount had it been ratably includible over the three-taxable-year period ending with the beneficiary's death, or other termination of existence in the case of a beneficiary not an individual.

Thus, the tax attributable to the amounts described in paragraph (1)(B), although assessable as part of the tax for the last taxable year of the decedent, cannot exceed what would have been the tax attributable to such amounts had they been includible in gross income one-third in his last taxable year and one-third in each of the two taxable years immediately preceding his last taxable year. Mechanically, the tax computation in this regard would be similar to computations made under the last sentence of section 668(a). The tax attributable to the amounts described in paragraph (1)(B) would in each instance be the difference between the tax determined with such amount included in gross income and the tax determined with such amount not included in gross income.

SECTION 106. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS

Section 661(a). Deduction for distributions

This section is substantially the same as section 106 of the House bill. Under existing section 642(c), the estate or trust is entitled to a deduction for amounts of gross income which are paid, permanently set aside, or to be used for charitable purposes. The amendment to section 661(a) made by section 106(a) of your committee's bill treats charitable distributions as distribution deductions.

The bill changes the deduction for charitable contributions in important respects. Existing law permits a deduction for contributions only if paid out of gross income. Under the House bill charitable deductions would have been permitted for distributions to charity irrespective of the source of the distribution, whether from income or corpus. Your committee's bill changes this rule with respect to amounts permanently set aside for one or more of the purposes described in section 170(c), or to be used exclusively for charitable, etc., purposes, to require that, in order to qualify for deduction, such amounts must be out of gross income for the taxable year. The aggregate of all the deductions under section 661 (including the charitable deductions) cannot exceed the distributable net income of the estate or trust.

As amended, the deduction for amounts permanently set aside or to be used for charitable, etc., purposes is limited to that portion of distributable net income which is not absorbed by distributions to beneficiaries in the three tiers set forth in paragraphs (1), (2), and (3) of section 662(a). The importance of the treatment of charitable distributions lies in its effect on the noncharitable beneficiaries rather than upon the amount of the deduction allowable to an estate or trust and is discussed under the amendment to section 662(a). The character of amounts paid, permanently set aside or to be used for charitable, etc., purposes is determined in the same manner as the character of amounts distributed to non-charitable beneficiaries is determined under existing law.

The other changes made in section 661(a) are conforming changes to reflect the three-tier system contained in section 662(a) as amended by section 107(a) of the bill.

Section 661(b). Conforming amendment

This section of the bill, which is identical to section 106(b) of the House bill, makes a conforming amendment to section 661(b) necessitated by the proposed revision of treatment of distributions to charitable beneficiaries, and, in addition inserts "or applicable local law."

SECTION 107. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS

Section 662(a). Inclusion

Under present law beneficiaries receiving income, other than those receiving income required to be distributed currently, are placed in the same class with beneficiaries receiving corpus for purposes of allocating distributable net income of an estate or trust. As a consequence, if the distributable net income of an estate or trust exceeds the amount of income required to be distributed currently, the beneficiaries receiving distributions of corpus and the beneficiaries receiving discretionary payments of current income are required to include in gross income proportionate parts of the balance of the distributable net income remaining after required distributions of income. This occurs even if all of the distributable net income of the estate or trust for the taxable year in fact has been distributed to beneficiaries of income. Beneficiaries entitled to, or who receive, distributions which can be made solely out of corpus may be required to include in their gross income a part of the distributable net income of the estate or trust for the taxable year.

As amended by section 107(a) of your committee's bill, which corresponds to amendments in section 107(a) of the House bill except for clarifying changes and the inclusion of charitable distributions in the third tier, a three-tier order of priority is established for determining the extent to which distributions shall be included in the gross income of beneficiaries having different interests in the income or corpus of the estate or trust. In the first tier are amounts which are required to be distributed out of current income or which, in the discretion of the fiduciary, may be paid or credited only out of current income. In the second tier are amounts which may be paid or credited either out of current income or out of corpus (including accumulated income of prior years). In the third tier fall all other amounts paid, credited, or required to be distributed during the taxable year, including all amounts properly paid for one or more of the purposes described in section 170(c).

If the amounts distributed to any class of beneficiaries exceed the distributable net income available to such class, each beneficiary must include such portion of the available distributable net income as the amount received by him bears to the amounts received by all beneficiaries in the same class.

The following examples indicate the results of the above amendments (assuming in each case that no accumulation distribution subject to the throwback rule is made):

EXAMPLE I

Distributable net income	$40,000
Distributions:	
To A, required income payment (tier 1)	15,000
To B, discretionary income payment (tier 1)	20,000
To C, discretionary income or corpus (tier 2)	25,000
To D, discretionary payment which can be made only out of corpus (tier 3)	30,000
Results:	
A received and is taxed on	15,000
B received and is taxed on	20,000
C received $25,000 and is taxed on	5,000
D received $30,000 and is taxed on	0

EXAMPLE II

Distributable net income	40,000
Distributions:	
To A:	
(1) required income payment (tier 1)	15,000
(2) discretionary income or corpus payment (tier 2)	15,000
Total distributions to A	30,000
To B: (3) discretionary income payment (tier 1)	15,000
Results:	
A is taxed on (1) entire required income payment	15,000
B is taxed on (3) entire discretionary income payment	15,000
A is taxed on part of (2) discretionary income or corpus payment	10,000
Total distributable net income	40,000

If a beneficiary is given an annuity of $1,000 a year which is to be paid out of income to the extent available and the balance is to be paid out of corpus, such beneficiary will be in tier 1 with respect to the income available to pay the annuity and in tier 3 with respect to the corpus which is required to be used to pay the annuity. On the other hand, if the beneficiary is to be paid $1,000 a year and the trustee is given discretion to pay such sum out of either income or corpus, then the beneficiary is in tier 2 with respect to the entire $1,000 whether the stated sum is paid out of income or out of corpus, or both.

Under your committee's bill a distribution to a charitable beneficiary does not affect the treatment of the distributions to noncharitable beneficiaries who fall in either tier 1 or tier 2 under section 662(a) but will affect the treatment of all other noncharitable beneficiaries who, along with charitable distributions, fall in tier 3. It should be noted that under the amended section 661(a)(4), amounts permanently set aside for one or more of the purposes described in section 170(c) or to be used for charitable, etc., purposes are, in effect, always in a fourth tier.

For example, A establishes a trust under the terms of which the trustee in his discretion may make payments to the X charity but only out of current income and may make payments out of corpus to A's wife W. The distributable net income of the trust in the first year is $10,000. The trustee pays $8,000 to the X charity and $8,000 to W. By making the charity a tier 3 beneficiary, W will be taxable on $5,000 of the $8,000 she receives. If instead of making the payment to the X charity, the $8,000 is permanently set aside for one or more of the purposes described in section 170(c), W would be taxable on the entire $8,000 she receives.

Section 662(b). Character of amounts

The amendment made by section 107(a) to section 662(b) which is identical to the House bill is a conforming amendment in connection with the revised treatment of distributions to charitable beneficiaries made by the amendment to section 642(c). It also inserts "or applicable local law" in order to make it clear that if local law specifies an allocation of different classes of income to different beneficiaries, it will be given the same effect as if made by the terms of the governing instrument.

Section 662(c). Different taxable years

The amendment to section 662(c) made by section 107(a) of your committee's bill provides for estates and complex trusts rules relating to different taxable years which are similar to the rules provided for simple trusts by the new section 652(c). A similar change was made by section 107(a) of the House bill, and your committee's bill changes the House amendment just as it changes the House amendment of section 652(c).

Effective date

Under section 107(b) of your committee's bill, the amendment to section 662 will apply only in the case of taxable years of estates and trusts ending after the date of enactment. Thus, although the taxable year of the beneficiary ends after the date of enactment, the amendment to section 662 would not be applicable unless the taxable year of the estate or trust also ends after the date of enactment.

SECTION 108. SPECIAL RULES APPLICABLE TO SECTIONS 651, 652, 661 AND 662

Section 108 of your committee's bill corresponds to section 108 of the House bill with changes in section 108 (a) and (c) as hereinafter mentioned.

Section 663(a)(1). Exclusions—Gifts, bequests, etc.

Section 663(a)(1) of present law excludes from the terms of section 661(a) and 662(a) certain gifts or bequests of specific sums of money or specific property paid or credited all at once or in not more than three installments (other than amounts which can be paid or credited only from income of the estate or trust). Consequently, payments of such specific gifts or bequests of corpus are not deductible by the estate or trust under section 661(a) and are not includible in income of the recipient under section 662(a).

Under section 108(a)(1) of your committee's bill, section 663(a)(1) is amended in several respects. The exclusion with respect to certain gifts or bequests which are paid or credited all at once is amended to include gifts or bequests which are distributed within 1 taxable year of the estate or trust, provided that the terms of the governing instrument do not require them to be paid in more than 1 taxable year. For example, a specific bequest of $100,000 to be paid 5 years after the date of death of the decedent is excluded under the amendment provided it is paid within 1 taxable year. The three-installment exclusion of existing law has been changed so that the exclusion applies to all installments, however many there may be, paid before the close of the

36th calendar month which begins after the date of the death of the testator or grantor, provided that under the terms of the governing instrument no installment is required to be distributed after the close of such 36-month period. Accordingly, if a decedent's will provides for the payment of $100,000 to a beneficiary, payment to be made in five installments 6 months apart, commencing 1 month following the decedent's death, each payment will qualify for the exclusion under section 663(a)(1) if in fact such payment is made before the close of the 36-month period. The exclusion will apply to payments made before the close of the period even if one or more of the payments is made after the close of the period. The 36-month rule will not apply to any amount, however, if under the terms of the governing instrument any part of the amount is required to be paid after the close of the 36-month period.

Under existing law, the exclusion under section 663(a)(1) applies to distributions by inter vivos and testamentary trusts as well as to distributions by estates. The House bill would eliminate distributions by inter vivos trusts from the provisions of section 663(a)(1), except for distributions by those inter vivos trusts which, immediately before the grantor's death, were revocable by the grantor acting alone. Your committee's bill modifies the House bill in that it eliminates distributions by all inter vivos trusts from the new provisions of section 663(a)(1).

Under section 108(a)(2) of the House bill, the amendment to section 663(a)(1) is to apply only with respect to estates and trusts of decedents dying after the date of the enactment of the bill. Under the House bill the rules of section 663(a)(1), prior to amendment, continue to apply (1) with respect to distributions by estates and trusts of decedents dying before such date of enactment, and (2) with respect to distributions by trusts which are in existence on the date of enactment and which, on such date, are not revocable by the grantor acting alone. Your committee's bill modifies the House bill so that the rules of existing law would continue to apply to distributions by a trust in existence on date of enactment only to the extent the trust on such date, was not revocable by the grantor or a nonadverse party, or both.

Since the rules of section 663(a)(1), prior to amendment, will continue to apply to existing trusts and estates for many years, such rules have been retained in section 663(a)(1), but limited in their application as set forth above.

Section 663(a)(2). Distributions in kind

Under existing law, the exclusion provided by section 663(a)(1) has in some situations proved too narrow. For example, the receipt of the family car by a widow under a residuary bequest has been susceptible of giving rise in her hands to taxable income, particularly if the car is distributed before the final distribution.

Section 108(a)(1) of your committee's bill revises the new section 663(a)(2) of the House bill to provide that if any real property, tangible personal property (other than money), or closely held stock, owned by the decedent at the time of his death is paid in full or partial satisfaction of a bequest, share, award, or allowance from the corpus of a decedent's estate, the amount equal to the value of such property will not be deductible under section 661 nor includible in income under section 662. The distribution, however, must be made before the close of the 36th calendar month beginning with the 1st month following the date of death of the decedent.

For purposes of the new exclusion provided by section 663(a)(2), the term "closely held stock" means stock in a corporation carrying on a trade or business if it meets the following two requirements: First, as of the time of decedent's death either 20 percent or more in value of the voting stock of such corporation must be included in determining the gross estate of the decedent, or such corporation must have 10 or less stockholders. Second, the value, for Federal estate tax purposes, of such stock which is included in determining the decedent's gross estate must exceed either 35 percent of the value of the gross estate or 50 percent of the taxable estate. For purposes of the second requirement, stock of two or more corporations, with respect to each of which there is included in determining the value of decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as stock of a single corporation. In determining whether more than 75 percent in value of outstanding stock of a corporation has been included in the decedent's gross estate, stock which at the decedent's death represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property shall be treated as having been included in the decedent's gross estate.

Section 108(a)(1) of the bill renumbers paragraph (3) of section 663(a), as revised by the House bill, so that it is now paragraph (5) and adds a new paragraph (3) which excludes from the operation of sections 661(a) and 662(a) distributions of amounts in full or partial satisfaction of an award or allowance under applicable local law for the support of a surviving spouse or dependents for a limited period during the administration of the estate. To qualify for this exclusion the amount must be properly paid or credited from the corpus of a decedent's estate during the period beginning with the day following the death of the decedent and ending 36 months thereafter.

n addition to the above provisions, section 108(a) of your committee's bill adds to section 663(a) a new paragraph (4) which provides that in the case of an estate in which the value of the gross estate is $100,000 or less, any amount properly distributed from the corpus of a decedent's estate before the close of the 36th calendar month which begins after the date of death of the decedent will not be deductible under section 661 nor includible under section 662. For purposes of this provision "gross estate" is defined as the gross estate for Federal estate tax purposes less the value of any property includible therein only by reason of sections 2035, 2036, 2037, 2038, 2039, 2040, 2041, and 2042(2). The value is to be determined as of the date of death of decedent whether or not the optional valuation date is elected. For purposes of this provision a payment shall be deemed to have been made from the corpus of a decedent's estate to the extent it is properly charged against corpus and designated as a distribution of corpus on the books and records of the estate by the fiduciary.

Section 663(a)(5). Denial of double deduction, etc.

In view of the treatment of amounts permanently set aside for a charitable beneficiary as distributions deductible under section 661 and the proposed repeal of present section 642(c), present section 663(a)(2) has been deleted as unnecessary for future years. However, section 663(a)(3) is amended to broaden its application so that it will prevent a deduction under section 661 for an amount distributed to a charitable beneficiary in a future year, for which a deduction was allowed under section 642(c) in a year prior to the effective date of the proposed amendment as an amount permanently set aside for a charitable beneficiary.

Section 663(c). Separate shares

Under existing law, in certain situations separate shares of a complex trust are treated as separate trusts. The amendments to section 633(c) made by section 108(b)(1) of your committee's bill, like the House bill, extend the separate share rule to estates and simple trusts and also apply the deduction carryover provisions of section 642(h) to the termination of a single beneficiary's entire interest in the estate or trust.

Applicability of the separate share rule of section 663(c), as amended, to estates and trusts and their beneficiaries will be required even though separate and independent accounts are not maintained, nor required to be maintained, for each share, and even though no physical segregation of assets is made or required. If a trust or estate has more than one beneficiary and if such beneficiaries have separate and independent shares, such shares shall be treated as separate trusts or estates for the purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 651, 652, 661, and 662.

It is not intended that section 663(c) should operate so as to result in income being attributed to beneficiaries of estates to whom corpus payments are made which are excluded under section 663(a) from amounts falling within sections 661(a) and 662(a).

Under section 108(b)(2) of the bill, the amendment to section 663(c) will apply only in the case of taxable years of estates and trusts ending after the date of the enactment of the bill. Thus, present law will apply if the trust's taxable year does not end after the date of enactment even though the beneficiary's taxable year ends after such date of enactment.

Section 663(d). Required distribution to another trust

Section 108(c)(1) of the bill, generally corresponding to section 108(c)(1) of the House bill, adds to section 663 a new subsection (d) which provides that under certain circumstances, for example, where there is a so-called "peel off" distribution from an existing trust to a newly created trust for the benefit of an afterborn child, the distributing trust will be entitled to a deduction only to the extent of a portion of its distributable net income. This amount, to be determined under regulations prescribed by the Secretary or his delegate, is to consist of the amount representing the receiving trust's share of the distributable net income of the existing distributing trust for so much of the distributing trust's taxable year as begins on the first day of such year and ends on the date of distribution to the receiving trust. The receiving trust shall include such amount in its gross income for its first taxable year which ends on or after the date of distribution. The House bill applied to taxable years ending *after* such date.

The new section 663(d) will apply only where, under the terms of the governing instrument or applicable local law, the distribution to the receiving trust is required and is not payable solely out of income, and it will not apply if the distribution is related to the occurrence of an event which results in the termination of the entire distributing trust.

The new section 663(d) is complementary to the new section 665 (b)(5) and (e), as added by section 110 (b) and (d) of the bill.

Under section 108(c)(2) of the bill, the new section 663(d) will apply only with respect to distributions made after the date of the enactment of the bill.

SECTION 109. POWER IN PERSON OTHER THAN GRANTOR TO VEST CORPUS OR INCOME IN HIMSELF

Section 664. In general

Section 678 of present law taxes a person, other than the grantor, as the owner of any portion of a trust over which he has a power exercisable solely by himself to vest corpus or income in himself.

Your committee's bill repeals section 678 and substitutes therefor a new section 664. Section 109 of your committee's bill conforms to section 109 of the House bill, except for changes noted below. Section 664(a)(1) causes the person who has a power to withdraw income or corpus (or both), whether or not the power is exercised, to be taxed under the tier system in the same way as a beneficiary to whom income or corpus, or both, is required to be distributed.

Under section 664(a)(2), where a person has a power exercisable by himself alone, or by himself and one or more related or subordinate parties, to withdraw an amount of corpus, the trust income for the taxable year attributable to such amount of corpus is deemed to be an amount of income required to be distributed currently under the tier system. For purposes of section 664(a)(2) there is taken into account only income attributable to that portion of the taxable year which begins on the first day during such taxable year on which the power becomes exercisable and ends on the day on which the power is exercised. Although the person who has a power to withdraw income or corpus, or both, will be taxed as a beneficiary, section 664(e) makes it clear that, for purposes of chapter 1, other than subchapter J, such person will continue to be treated as the owner of that portion of the trust with respect to which he has such power.

Section 664 as added by the House bill applied only if a person other than the grantor had a power exercisable solely by himself to vest an amount of corpus or income of a trust in himself. Section 664 as added by your committee's bill applies whether such power is exercisable by such person alone or in conjunction with one or more related or subordinate parties. In view of this change, your committee's bill adds a new section 664(a)(3) which provides that, for purposes of paragraphs (1) and (2) of section 664, the term "related or subordinate party" has the meaning assigned to it by section 672(c), except that the term "person" is substituted for the term "grantor" each place it appears in such section.

If a person other than the grantor has a power to make limited withdrawals annually and the power is cumulative so that if a withdrawal is not made in one year it may be made in the next year in addition to the withdrawal which normally could be made in the next year, section 663(a)(3) prevents such person from being subjected to taxation on the amount subject to withdrawal after the first year in which it became so subject to withdrawal.

Section 664(c) as added by the House bill applied only to the income of a trust whereas section 664(c) as amended by your committee's bill applies to both income and corpus.

The operation of section 664 is demonstrated in the following illustrations:

1. A establishes a trust which gives his wife W power to withdraw a limited amount of corpus each year. The new section 664(a)(1) causes W to be subject to taxation under the tier system (as a tier 3 beneficiary) each year as though the limited amount of corpus which she can withdraw were required to be distributed to her each year, whether she makes the withdrawal or not. Under section 664(a)(2) the income attributable to the corpus over which W has the power to withdraw will be considered each year to be an amount of income required to be distributed currently to W and not an amount paid, credited, or required to be distributed currently to any other person. Thus, W will be treated as a tier 1 beneficiary with respect to such amount.

2. B establishes a trust which provides that 1 day after the end of the taxable year his wife, W, may withdraw the income of the previous year. The new section 664(a)(1)(B) causes W to be treated as a tier 3 beneficiary under section 662, and, as such, W will be subject to the 5-year throwback rules. Thus, to the extent the amount withdrawable by W is not taken into account currently, it will be thrown back to the preceding taxable year.

3. C establishes a trust under which (throughout the taxable year) W has a power to withdraw $10,000 of corpus and the income attributable to such amount of corpus. The income attributable to the $10,000 of corpus is $500. W will be treated as a tier 1 beneficiary for the taxable year only with respect to $500 even though, by their terms, both sections 664(a)(1) and (a)(2) apply.

Effective date

The new section 664 (and the repeal of sec. 678) apply in the case of taxable years of trusts beginning on or after the date of enactment and with respect to periods included in such taxable years. Thus, a person holding a power described in section 664 may be required to split his taxable year between the treatment under sections 664 and 678. For example, if the taxable year of the trust begins 3 months after date of enactment and the taxable year of the person holding the power ends 6 months after the date of enactment, section 678 will apply with respect to the first 9 months of such person's taxable year and section 664 will apply with respect to the last 3 months of his taxable year.

SECTION 110. DEFINITIONS RELATING TO TREATMENT OF EXCESS DISTRIBUTIONS BY TRUSTS (SUBPART D)

Sections 665(a)(1) and 665(b). Conforming amendments

Sections 110 (a) and (b) of the House bill made changes in section 665(a)(1) and in section 665(b) to conform those provisions with the amendments to the tier system contained in section 661. Sections 110 (a) and (b) of your committee's bill make the same changes with one exception. Under section 665(a)(2) as amended by the House bill, in determining undistributed net income for any taxable year, there was taken into account any amount paid, permanently set aside, or to be used for charity. Under section 110(a) of your committee's bill, this provision is deleted. The effect of this deletion, plus your committee's revision in the tier system, is to take into account in determining undistributed net income for any taxable year only those amounts which are actually paid to charity—that is, amounts properly paid for one or more purposes described in section 170(c) for which a deduction is allowed under section 661(a)(3). Amounts permanently set aside, or to be used for, charitable purposes, for which a deduction is allowed under section 661(a)(4), will not, therefore, be taken into account to reduce undistributed net income.

Section 665(b)(3). Amounts payable on a specified date or dates

Under present law amounts properly paid or credited to a beneficiary upon such beneficiary's attaining a specified age or ages will not be included in the determination of an "accumulation distribution" if—

(1) The total number of such distributions cannot exceed four with respect to such beneficiary;

(2) The period between each such distribution is 4 years or more; and

(3) As of January 1, 1954, such distributions are required by the specific terms of the governing instrument.

Section 110(b) of the House bill amended paragraph (3) of section 665(b) to make it applicable to amounts paid or credited to a beneficiary "upon a specified date or dates," as well as "upon such beneficiary's attaining a specified age or ages." Section 110(b) of your committee's bill makes the same change.

Section 665(b)(4). Final distribution—9-year rule

Under present law, a final distribution of a trust is excepted from the 5-year throwback rules if "such final distribution is made more than 9 years after the date of the last transfer" to the trust.

Section 665(b)(4) was amended by section 110(b) of the House bill so that the 5-year throwback will be applicable only to the extent that the final distribution is attributable to property transferred to the trust not more than 9 years prior to such distribution and the income attributable to such transferred property. Section 110(b) of your committee's bill makes the same change.

Example under section 665(b)(4)

Under the terms of a trust created June 1, 1950, by H for the benefit of his wife, W, with an original corpus contribution of $100,000, the income is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including accumulated income, are to be distributed to W.

On January 1, 1957, when the value of all assets of the trust was $120,000, S added $20,000 to the trust.

The trust terminated on June 30, 1960, and on August 1, the trustee made final distribution of assets of the trust consisting of the following:

1. Principal and income accumulated for the period June 1, 1950, to Dec. 31, 1956	$120,000
2. Addition to principal Jan. 1, 1957	20,000
3. Accumulated income for period Jan. 1, 1957, to Dec. 31, 1959	14,000
4. Income during period trust was in existence in 1960	1,000

The accumulated income of $14,000 must be allocated between the property in the trust for more than 9 years, which would not be subject to the 5-year throwback, and that in the trust for less than that period, which would be subject to such throwback. This is done by determining the amount added to accumulated income each year after 1956 to reach the total income accumulated between January 1, 1957, and December 31, 1959, by identifying the portion representing income attributable to the addition to corpus in 1957, or, if that is not possible, by using fractions obtained by reference to the value of the trust property at the time the addition was made.

Where fractions are used, the addition by S of $20,000 to the trust in 1957 requires treating 20,000/140,000 of the trust income for the period between the date of the addition and December 31, 1959, as income subject to the 5-year throwback.

By using fractions in the above example, the accumulation distribution is $22,000 (the $20,000 added on January 1, 1957, plus 20,000/140,000 of $14,000). The balance of the distribution would not be subject to the 5-year throwback in view of the amendment to section 665(b)(4).

In the above example, $1,000 of income of the trust during the period it was in existence in 1960 would not be subject to the 5-year throwback since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in sections 661 and 662.

Section 665(b)(5) and (e). Peel off trusts, etc.

Under paragraph (6) as added to section 665(b) by section 110(b) of the House bill, where the terms of the governing instrument or applicable local law require a trust to make a distribution, not payable solely out of income, to another trust, upon the occurrence of an event unrelated to the termination of the distributing trust, such distribution will not be treated as an accumulation distribution for purposes of the throwback rule. Section 110(b) of your committee's bill makes the same change, redesignating it as paragraph (5). This exception would apply, for example, where the grantor provides that upon the occurrence of an event, such as the birth of a child, existing trusts are to contribute a trust fund to or for another trust (either existing or newly created).

Sections 665(b)(5) and (e) of your committee's bill provide that a proportionate share of the undistributed net income of each of the distributing trusts (and taxes imposed on such trusts) for the preceding taxable years will be allocated to the receiving trust. The portion of the undistributed net income for each of the preceding taxable years so allocated will be deemed undistributed net income of the receiving trust, even though the receiving trust was not in existence. Similarly, the portion of the taxes imposed on the distributing trust, allocated to the receiving trust, will be deemed to be taxes imposed on and distributed to the receiving trust. The undistributed net income of, and taxes imposed on, the distributing trust shall be correspondingly reduced. In addition, section 663(d) (added by sec. 108(c)(1) of the House bill and of your committee's bill) insures that the receiving or peel off trust will include in gross income, and the distributing trust will deduct from distributable net income, only the receiving trust's share of the distributable net income of each existing (contributing) trust for its taxable period up to the time of distribution to the receiving trust.

Example of peel off trusts

A transfers property to T to hold in trust for the benefit of his child now living. The instrument provides, however, that a separate trust is to be established for each child of A who is subsequently born and the trust fund of each new trust is to consist of contributions from existing trusts so that the new trust will initially have a fund equal in value to the value of the existing trusts divided by the number of existing trusts plus one. The trusts which exist at the time of the birth of another child will, therefore, each contribute to a new trust in the proportion that the value of an existing trust bears to the aggregate value of all the existing trusts. The trustee is authorized to pay the income of each separate trust to the child for whose benefit it is established or to accumulate the income, and is further authorized to pay corpus and accumulated income to such child.

At the time the trust is established A has one child. He places $110,000 in the trust. For its first taxable year, the undistributed net income of the trust is $3,260, and the tax imposed on the trust is $840.

During the second taxable year of the trust a second child is born. On the date of the distribution to the trust for the second child the value of the property in the trust for the first child is $120,000. The existing trust will contribute $60,000 to the new trust so that each trust will contain $60,000. Assume that the distributable net income of the existing trust for that portion of its taxable year ending on the date of the distribution to the new trust is $800. The amount allocable (under regulations) to the new trust is $400, which it must include in its gross income. The existing trust will be entitled to a deduction of $400.

Under section 665(e), for purposes of the throwback rule the $3,260 of undistributed net income of the existing trust will be reduced by $1,630, and the new trust will have undistributed net income of $1,630. The $1,630 is arrived at by multiplying $3,260 by $\frac{\$60,000}{120,000}$. For purposes of applying the throwback rules to subsequent distributions by either trust, one-half of the taxes for the prior year imposed on the existing trust ($420) will be deemed to have been imposed on the new trust for such prior year, and the taxes imposed on the existing trust will be correspondingly reduced. It is to be noted that the liability for tax of the existing trust is not affected for any prior taxable year by the operation of the peel off provisions.

Paragraph (5) of section 665(b), as added by section 110(b) of the House bill, excepted from the operation of the 5-year throwback rules final distributions of a trust to a beneficiary upon his reaching an age specified in the governing instrument, if the trust was created by will, or if the trust was an inter vivos trust which (immediately before the grantor's death) was revocable by him acting alone. Your committee's bill deletes this provision.

Section 665(c). Pro rata portion of taxes deemed distributed

Section 110(c) of your committee's bill amends section 665(c) by deleting the reference therein to section 667. This change is the same as that made by section 113(b)(1) of the House bill. The reference to section 667 is no longer necessary because of the amendment of section 667 made by section 112 of your committee's bill.

Sections 665(b), 665(f), and 665(g). Foreign trust created by citizen or resident of the United States

By the addition of a new sentence at the end of section 665(b) and new subsections (f) and (g) to section 665, your committee's bill provides new treatment of distributions received from certain foreign trusts. These additions are made by subsections (b) and (e) of section 110 of your committee's bill. There were no comparable provisions in the House bill.

The new provisions deal with foreign trusts, defined in section 665(f) as trusts (created by citizens or residents of the United States) subject to tax under section 871 (or which would be subject to tax under section 871 if they had income from sources within the United States)—that is, trusts which are subject to tax only as nonresident aliens. A trust created by a U.S. citizen in a foreign country with a nonresident alien as trustee would, therefore, be treated as a foreign trust.

In the case of distributions to U.S. citizens or residents by foreign trusts, which are deemed to consist of income from foreign sources, or net capital gains which have not been subject to tax under section 871, the new provisions bar the application of the $2,000 limitation contained in section 665(b) and the exceptions contained in paragraphs (1), (2), (3), (4), and (5) thereof. Thus, any distribution of amounts described in section 661(a) (2) or (3) which exceeds distributable net income, reduced by the amounts specified in section 661(a)(1), would be considered an accumulation distribution, subject to the operation of the 5-year throwback in the hands of the beneficiary, pursuant to section 668. With respect to distributions deemed to consist of ordinary income from sources within the United States, and net capital gains which have been subject to tax under section 871, the limitation and exceptions contained in section 665(b) of existing law would continue to apply.

The new section 665(g) provides an exception in the determination of distributable net income of a foreign trust. For purposes of section 665(a), capital gains which have not been subject to tax under section 871 will be included in distributable net income, without regard to their nature under the governing instrument or applicable local law as income or corpus. The provisions of section 643(a)(3) for this purpose would be disregarded. The exception applies only in computing distributable net income for purposes of computing undistributed net income as defined in section 665(a). Thus, the exception would not apply to distributions deemed to come out of distributable net income of the current year in the application of sections 651, 652, 661, or 662, or in determining the amount of an accumulation distribution under section 665(b) where the current year's distributable net income is a factor.

In other respects, aside from those indicated, the existing throwback rules, as amended by the bill, will apply to distributions from foreign trusts as defined in section 665(f). Accordingly, for example, the credit for taxes paid by the trust will be available to the beneficiary pursuant to section 668(b). In addition, because of the interplay of the rules relating to the character of income received by a beneficiary of a trust and the provisions of section 901(b)(4), the beneficiary receiving a distribution from a foreign trust is entitled to a credit for his share of the foreign income taxes paid by the trust. This credit will, of course, apply in computing the limitation on tax provided by the last sentence of section 668(a).

SECTION 111. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS

Section 666. Conforming and clarifying changes

The words "paragraph (2)" in section 666 (the words appear once), in section 666(b) (the words appear twice), and in section 666(c) (the words appear twice), are deleted and there are inserted in each of such places the words "paragraph (3)". These changes, made by section 111 of your committee's bill correspond to changes made by section 111 of the House bill, and are made necessary by the change in the wording of section 661(a).

Section 111 of your committee's bill also makes amendments which correspond to section 113(b)(2) (A) and (B) of the House bill. Under this amendment, section 666 is amended by striking the last sentence of subsections (a), (b), and (c) and inserting a new subsection (d) which provides that the undistributed net income and the taxes imposed on the trust shall be computed without regard to any distribution under subpart D for the taxable year and any succeeding taxable year but with regard to such a distribution for any preceding taxable year. The new subsection (d) does not represent a change in law, but provides clarity by eliminating duplication of the last sentence of subsections (a), (b), and (c).

SECTION 112. DENIAL OF REFUND TO TRUSTS

Section 667. Denial of refund to trusts

Section 667 of present law provides that there shall be no refund to a trust for the amount of taxes imposed on the trust which would not have been payable had the trust in fact made accumulation distributions as determined under section 666. Section 667 also provides that the amount of taxes not refundable shall be available as a credit under 668(b) to beneficiaries. As revised by section 112 of your committee's bill, which corresponds to section 113(b)(3) of the House bill, section 667 only provides for a denial of a refund to the trust. Computation of the credit is made under section 668(b), as revised by your committee's bill.

SECTION 113. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS

Section 668(a). Treatment

Existing section 668(a) provides for the inclusion in the gross income of beneficiaries of amounts deemed distributed under section 666 on the last day of a preceding taxable year to the extent such amounts would have been included under existing section 662(a)(2) and (b) if such amounts had been paid on the last day of such preceding taxable year. Section 113(a) of your committee's bill makes conforming amendments to section 668 to take into account changes which have been made in the tier system and corresponds to section 112(a) of the House bill.

The amendment makes it clear that the amount deemed distributed under section 666 on the last day of the prior taxable year must be included in the gross income of the beneficiary to the extent that such amount would have been included under section 662(a)(3) if that section had applied and if such amount had been paid to the beneficiary on the last day of such preceding taxable year. In other words, all amounts which are treated as distributed in a prior taxable year under section 666 will be treated as if they were section 662(a)(3) amounts (that is, tier 3 amounts), and their character will be determined under section 662(b). The undistributed net income for such prior year will be computed under the law applicable to such year.

As amended, section 668(a) provides for the inclusion by a beneficiary of an amount deemed distributed by the trust under section 666 in the ratio which the aggregate of the amounts described in section 661(a)(2) and (3) paid, credited, or required to be distributed to such beneficiary for the taxable year (reduced by the distributable net income allocated to such beneficiary for such taxable year under sec. 662(a)(2) or (3)) bears to all such amounts paid, credited, or required to be distributed to all such beneficiaries for such taxable year under section 661(a)(2) or (3) (reduced by the amount of distributable net income for the taxable year allocable under sec. 662(a)(2) or (3)), with certain adjustments because of the exceptions to the throwback rules contained in section 665(b).

The operation of section 668, as amended by the bill, is illustrated by the following example:

EXAMPLE

Undistributed net income for 1960	\$6,000
Distributable net income for 1961	10,000
Distributions in 1961:	
To A, discretionary payment out of income or corpus (tier 2)	15,000
To B, discretionary payment out of corpus (tier 3)	7,500
Treatment of distributions in 1961:	
(1) Current distributions:	
A is taxed on (as a current distribution)	10,000
B is taxed on (as a current distribution)	0
(2) Accumulation distribution for 1961	12,500
(3) Portion of accumulation distribution deemed distributed on Dec. 31, 1960	6,000
A is taxed on	2,400
B is taxed on	3,600

Disregarding taxes paid by the trust, under the facts assumed in the above table the results with respect to the accumulation distribution shown in the table are achieved as follows:

With respect to A, the portion of the total (\$6,000) required to be included under the first sentence of section 668(a) in the income of beneficiary A shall be an amount (X) which bears the same ratio to such total (\$6,000) as the aggregate amount paid, credited, or required to be distributed to A and described in paragraphs (2) and (3) of section 661(a) (reduced by the amount of distributable net income for 1961 allocated under section 662(a) to such beneficiary, \$15,000−10,000=5,000), bears to all amounts paid, credited, or required to be distributed to all beneficiaries (in this case A and B) for 1961 and described in paragraphs (2) and (3) of section 661(a) (reduced by the amount of distributable net income for 1961 allocated to all beneficiaries under sec. 662(a)(2) or (3), $22,500-10,000=12,500). In this case no adjustment is required for amounts which fall within paragraphs (1) through (6) of section 665(b). The computations for A (and similar computations for B) may be summarized as follows:

A.............. $\frac{X}{6,000}=\frac{5,000}{12,500}$ or X equals $2,400 with respect to A.

B.............. $\frac{X}{6,000}=\frac{7,500}{12,500}$ or X equals $3,600 with respect to B.

Portion of accumulation distribution deemed distributed in 1960........... $6,000

Credit for taxes paid by trusts

Section 113(b) of your committee's bill, which corresponds to section 113(b)(4) of the House bill, amends section 668(b) to provide that the beneficiary will receive a credit against his tax in an amount equal to the taxes deemed distributed to such beneficiary under section 666 (b) or (c). Under present law, the beneficiary receives a credit equal to the portion of the taxes imposed on the trust which would not have been payable by the trust for the preceding taxable year had the trust in fact made distributions to such beneficiaries at the time and in the amounts specified in section 666. Thus, under existing law the amount of the credit might be greater than the amount of taxes deemed distributed. Under the amendment, the amount of the credit will always be equal to the amount of taxes deemed distributed.

Special transitional rule

Section 113(c) of the bill provides that in applying sections 666 and 668 to any preceding taxable year of a trust to which the amendments referred to in the bill do not apply, reference to sections 661(a)(3) and 662(a)(3) are to be treated as references to sections 661(a)(2) and 662(a)(2) as in effect before such amendments.

SECTION 114. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AS SUBSTANTIAL OWNERS

Section 114 of your committee's bill, like the House bill, amends section 671—

(1) to conform section 671 to the repeal of section 678 (relating to powers in persons other than grantors) by section 109(b) of the bill,

(2) to make it clear that, to the extent that items of income, deductions, etc., are to be taken into account by the grantor under the provisions of sections 671 through 677, such items are not to be subject to subparts A through D of part I of subchapter J, and

(3) to specifically recognize that persons other than individuals may be grantors of trusts.

SECTION 115. POWER TO CONTROL BENEFICIAL ENJOYMENT

In general

Section 674(a) contains the general rule that the grantor of a trust is to be treated as the owner of any portion of the trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition which is exercisable by the grantor or a nonadverse party (or both) without the approval or consent of any adverse party.

Section 674(b) provides that the general rule of section 674(a) is not to apply to certain listed powers, regardless of by whom held. Section 674 (c) and (d) also contain exceptions to the general rule of section 674(a).

Section 674(b)(3). Power exercisable by will or deed

Section 674(b)(3) of existing law excepts from section 674(a) a power exercisable only by will, other than a power to appoint the income of the trust where the income is accumulated for such disposition by the grantor (or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party).

Section 115(a) of your committee's bill, like the House bill, amends section 674(b)(3) to broaden the exception described above to include a power exercisable by deed (which is subject to the restrictions described in the preceding paragraph), where an exercise of such power could only affect the beneficial enjoyment of the corpus or income after the death of the holder of the power. The last sentence of the amended paragraph (3) of section 674(b) makes it clear that such paragraph does not apply to a power which does not exclude the grantor and his estate as possible appointees; the House bill referred in this connection only to a power exercisable by deed.

Section 674(b)(5). Power to distribute corpus—Exception to exception

Section 674(b)(5) of existing law excepts from the general rule of section 674(a) a power to distribute corpus under certain conditions. However, the exception of this power from the general rule is made subject to the limitation that the power will not be excepted—

> if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for afterborn or afteradopted children.

This limitation, which is set forth in the last sentence of section 674(b)(5), relates, in general, to a power to add new beneficiaries which exists concurrently with a power which is otherwise excepted from the general rule of section 674(a). This limitation, referred to as the "exception to the exception," is also imposed on the powers described in sections 674(b)(6), 674(b)(7), 674(c), and 674(d).

Section 115(b) of your committee's bill, like the House bill, amends the last sentence of section 674(b)(5), relating to the exception to the exception. The House bill contained a provision that the prohibition against a power to add new beneficiaries does not apply to a power held by an adverse party nor to a power which qualifies as an exception under section 674(b)(3). This provision is deleted in your committee's bill. By substituting the word "change" for the word "add", the amendment also makes it clear that the prohibition against a power to add beneficiaries includes a power to change beneficiaries. Under present law, provision for afterborn or afteradopted children is excepted from the prohibition against a power to add beneficiaries. As amended, provision for an afteracquired spouse is also excepted from the prohibition.

The amendments described above have also been made with respect to the exception to the exception found in sections 674(b)(6), 674(b)(7), 674(c), and 674(d).

Section 674(b)(6). Power to withhold income temporarily

Section 674(b)(6) of existing law (which is an exception to the general rule of sec. 674(a)) relates to a power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him on condition that the accumulated income is ultimately payable in one of the ways specified in the statute. Section 115(c)(1) of the House bill amended section 674(b)(6) to clarify its application, and to provide that, under the circumstances provided in the bill, the grantor and his estate must be excluded from the class of possible appointees. Under your committee's bill, the requirement that the grantor and his estate must be excluded from the class of possible appointees has been deleted except as it appears in section 674(b)(6)(C), and in the latter case the exclusion has been made permissive. Under section 115(c)(2) of the bill, this change will take effect 1 year after the date of the enactment of the bill.

The amendment also changes the "exception to the exception" contained in the last sentence of section 674(b)(6). This change is explained in connection with the explanation of the change in the last sentence of section 674(b)(5).

Section 674(b)(7). Power to withhold income during disability of beneficiary

Section 115(d) of your committee's bill, like the House bill, amends section 674(b)(7) to change the "exception to the exception" contained in the last sentence. This change is explained in connection with the explanation of the change in the last sentence of section 674(b)(5).

Section 674(c). Powers of independent trustees

In general, section 674(c) of existing law excepts from section 674(a) a power solely exercisable by a trustee or trustees—

> none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

to distribute, apportion, or accumulate income, or to pay out corpus, to or for a beneficiary or class of beneficiaries.

Under section 674(c), as amended by section 115(e) of your committee's bill and the House bill, the exception applies only if the power is solely exercisable by a trustee or trustees—

> other than the grantor and which is not exercisable without the concurrence of a trustee who is not a related or subordinate party subservient to the wishes of the grantor.

Thus, if the grantor establishes a trust and gives the trustees a power to spray income or corpus among described beneficiaries and designates his wife, his son, and X trust company (an independent trustee) as trustees, the exception described in section 674(c), as amended by the bill, will apply only if the power is not exercisable without the concurrence of X trust company.

The amendment made by section 115(e) of your committee's bill also changes the "exception to the exception" contained in the last sentence of section 674(c). This change is explained in connection with the explanation of the change in the last sentence of section 674(b)(5).

Section 674(d). Power to allocate income

Section 115(f) of your committee's bill, like the House bill, changes section 674(d) in two respects. In the first sentence the words "none of whom is the grantor" are replaced by "other than the grantor". This is a conforming amendment and makes no substantive change in existing law.

The second change is a revision of the last sentence of section 674(d) which contains the "exception to the exception". This change is explained in connection with the explanation of the change in the last sentence of section 674(b)(5).

SECTION 116. ADMINISTRATIVE POWERS

The amendment made by section 116 of your committee's bill, like the House bill, to section 675(2) is a clarifying amendment. Under existing section 675(2), the grantor is treated as the owner of any portion of a trust in respect of which he is enabled to borrow corpus or income without adequate interest or security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. The amendment strikes out "(other than the grantor)" and inserts "(other than the grantor acting alone)". Thus, the grantor would not be treated as owner where he is one of two or more trustees holding such a general lending power jointly.

SECTION 117. INCOME FOR BENEFIT OF GRANTOR

Section 677(b). Conforming change

Section 117(a) of your committee's bill, like the House bill, amends section 667(b) to conform to the changes made by the bill in section 661(a).

Section 677(c). Existence of discretion as to income

Existing section 677(a) provides (in part) that a grantor is to be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or applied to the payment of premiums on certain policies of insurance on the life of the grantor.

Existing section 677(b) provides (in part) that income of a trust is not to be considered taxable to the grantor under section 677(a) or any other provision of chapter 1 of the code merely because such income (in the discretion of another person, the trustee, or the grantor acting as trustee or cotrustee) may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed.

Section 117(b) of your committee's bill, like the House bill, adds a new subsection (c) to section 677. The new subsection provides, in effect, that discretion as to income exists for purposes of the provisions of section 677(a) and (b) described above even though the terms of the trust specify that the discretion relates only to corpus, to the extent that the income of the trust is not required to be distributed currently.

The application of the new section 677(c) may be illustrated as follows: A establishes a trust and gives the trustee discretion to pay out the income to his son S or to accumulate it. A reserves the power to withdraw $5,000 of corpus each year. The ordinary income of the trust exceeds $5,000. A will be treated as the owner of $5,000 of ordinary income, whether the income is paid to S or not and whether A makes a withdrawal or not.

SECTION 118. LIMITATION ON CHARITABLE, ETC., DEDUCTION

Section 118 of your committee's bill, like the House bill, makes conforming amendments to section 681 to implement the change in the treatment of distributions to charitable beneficiaries. (See comment under section 642(c).) It also amends section 681(b)(1) and the last sentence of section 681(c) to make it clear that a trust may obtain the benefit of section 170(b)(1)(A) which allows the extra 10 percent deduction for contributions to a specified class of charities. Your committee's bill changes the House bill to conform to changes made in section 661.

SECTION 119. TECHNICAL AND CONFORMING AMENDMENTS

Section 119 of your committee's bill, like the House bill, makes a number of technical changes to the code to conform its provisions to changes made by the bill in subchapter J. The changes made by section 119(b), relating to constructive ownership of stock, and section 119(e), relating to deduction for capital gains, are to preserve the effect of existing law with respect to attribution rules provided by section 318 of the code and with respect to the computation of the deduction for capital gains under section 1202 of the code in the case of estates and trusts.

Subsections (h) and (i) provide special 6-year periods of limitation on assessment and collection and on claims for credit and refund in the case of multiple trusts subject to the operation of section 641(c). The 6-year period will apply only to the extent a tax is attributable to currently accumulated incomes or taxable incomes allocated to corpus, or both, of separate trusts which are combined under section 641(c).

SECTION 120. CLERICAL AMENDMENTS

Section 120 of your committee's bill, like the House bill, makes clerical changes in tables of sections and headings.

SECTION 121. EFFECTIVE DATE

Section 121 of your committee's bill, like the House bill, provides that except as otherwise provided in title I of the bill, the amendments made by title I of the bill shall apply with respect to taxable years ending after the date of the enactment of the bill.

III. GENERAL EXPLANATION OF PARTNERSHIP PROVISIONS

1. Rearrangement of subchapter K

The present partnership provisions are divided into four parts with one of these parts subdivided into four subparts. The parts and subparts of existing law are as follows:

Part I. Determination of tax liability
Part II. Contributions, distributions, and transfers
  Subpart A. Contributions to a partnership
  Subpart B. Distributions by a partnership
  Subpart C. Transfers of interests in a partnership
  Subpart D. Provisions common to other subparts (including the collapsible partnership provision)
Part III. Definitions
Part IV. Effective date

The present partnership provisions have been criticized on the grounds that they are too complicated and that the taxpayer who is a member of the average simple partnership cannot be expected to understand many of the present provisions. Your committee agrees with the House that much of the difficulty in this respect stems from the fact that, in actual practice, the operation of partnerships can vary significantly. The major problem appears to arise from the fact that a partnership is viewed by some as an entity separate and apart from the partners, while others view the partnership as an aggregation of the partners, each acting in his own separate capacity. The partnership provisions of present law take both this "entity" and this "aggregate" concept into account. The "entity" concept is most frequently applied by the statute, since it ordinarily operates more simply than does the "aggregate" concept. Usually elections are available, however, making it possible for the partners or partnership to follow the aggregate concept if they care to do so. These elections are necessary if the tax laws are not to freeze partnerships into a rigid mold, but, nevertheless, they are a complicating factor. Moreover, there are other relatively complicated partnership provisions, designed to prevent tax avoidance or undue hardship, which are unlikely to apply in the type of transaction in which the simple partnership or partner normally engages.

The House and your committee have concluded that, in actual practice, a substantial simplification can be achieved for the average simple partnership by grouping in one part the provisions likely to be applicable to these partnerships and by grouping in other parts the various elections and other technical provisions of narrower application. Therefore, in both the House and your committee's versions of this bill a rearrangement of the partnership provisions is provided.

Both versions of the bill rearrange the partnership provisions so that the provisions generally applicable to a "simple" partnership fall in part I, the special provisions relating to collapsible partnerships fall in part II, and the more technical provisions fall in part III. The outline of the rearrangement provided is as follows:

Part I. Rules generally applicable to partners and partnerships.
  Subpart A. Determination of tax liability.
  Subpart B. Contributions to a partnership.
  Subpart C. Distributions by a partnership.
  Subpart D. Transfers of interests in a partnership.
  Subpart E. Treatment of certain liabilities.

Part II. Collapsible partnership transactions.
Part III. Special rules for partners and partnerships.
Subpart A. Special rules in determining tax liability.
Subpart B. Interest in partnership capital exchanged for services.
Subpart C. Termination of retiring or deceased partner's interest.
Subpart D. Election of optional adjustments to basis of partnership property.
Part IV. Definitions.

It is believed that any inconvenience that may be caused by a renumbering of sections under the new arrangement will be relatively minor because of the large proportion of old section numbers retained and because sufficient time has not yet transpired since the enactment of the 1954 Code to fix the existing numbers in practitioners' minds.

2. Section 702(b). Level for determining character of income

Section 702(b) of present law provides that only the items of income, gain, loss, deduction, or credit which were included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) of section 702 are to have special characteristics in the hands of the partner. After excluding such items, the remaining income or loss, grouped in paragraph (9), becomes ordinary income or loss without any character other than "partnership income or loss." As to whether the character of the items is to be determined at the partnership or partner level, the statute merely states that the character of the items in paragraphs (1) through (8) is to be determined as if the items were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Both the House and your committee's versions of the bill continue the conduit principle established by section 702(b) of present law. However, this principle is expanded by providing that the character of all partnership items, not just certain listed items, is to carry over into the hands of the separate partners. In reality this effect has already been obtained by the regulations which under existing authority provide that the character of all items of income, gain, loss, deduction, or credit, which have tax significance, is to carry over into the hands of the separate partners. This principle which is laid down in the regulations appears necessary in order to prevent a partner from being deprived of the benefit of such items as the retirement income credit where rents, dividends, etc., are received through a partnership.

In addition, both versions of the bill provide that the character of items of income, gain, loss, deduction, or credit is to be determined on a partner-by-partner basis, depending upon the activities of each partner. However, due regard must be given to any business, financial operation, or venture in which the partnership is engaged, since the partnership is carrying on this activity for the partner. As a result, the sale of a property by a partnership which is not a real estate dealer may result in ordinary income to one partner (who is a real estate dealer) and capital gain to the other partners (who are not real estate dealers in their separate capacities). However, just as it is possible for a real estate dealer who is a sole proprietor to have a segregated investment account (sales from which result in capital gain), so also will it be possible, where a partnership interest represents an investment account, for sales by the partnership to give rise to capital gain, rather than ordinary income, for the partner who is a real estate dealer. This will be a factual question to be determined in each case. It will, of course, also be necessary to take into account the activities of all partnerships where an individual is a partner in more than one partnership, in determining the character of these various activities for the partner. It is believed that a rule of this general type is essential to prevent serious tax avoidance since dealers otherwise might avoid ordinary income tax by combining in partnerships with nondealer partners.

3. Section 702(c). Gross income of a partner

Section 702(c) of present law states:

> In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

Gross income of the partnership as used here might not be reduced by any guaranteed payments made by the partnership to the partners. Section 707(c) of present law (sec. 707(b) in the bill), however, also provides that guaranteed payments are to be included in gross income for purposes of section 61(a).

As the result of the interrelationship of sections 702(c) and 707(c) ((b) in the bill) the law may be interpreted as requiring the inclusion of guaranteed payments in a partner's gross income twice, once as a portion of his distributive share of the partnership gross income and once directly as guaranteed payments. To overcome this possible double inclusion in gross income both the House and your committee's versions of the bill modify this provision to provide that for purposes of computing gross income under section 61(a) amounts included in gross income as guaranteed payments are not to be again included as "gross income of a partner."

4. Section 702(d). Limitations in computing taxable income (new subsection)

Although various sections of the code impose limits upon the amount of an item (generally a deduction item) which is to be taken into account in computing taxable income, subchapter K does not make it clear whether the code imposes these limitations at the partnership or at the partner level. Under the regulations, however, the limitations are applied at the partner level.

The types of limitations referred to include (but are not limited) the $50 exclusion of dividends received by individuals, the $1,000 limitation on the deduction of capital losses in excess of capital gains, the $100,000 limitation on deductible exploration expenditures, the limitation of soil and water conservation expenditure deductions to 25 percent of gross income from farming, the limitation of deductible charitable contributions to 20 or 30 percent of an individual taxpayer's adjusted gross income, the limitation on the deductible depletion allowance to 50 percent of taxable income from the property and the limitation on the foreign tax credit restricting the allowable credit to the portion of the taxpayer's taxable income from sources within the foreign country.

The bill makes it clear that wherever a limitation is imposed upon the includibility or the deductibility of an item, each partner is entitled to his full share up to the statutory limit and that the partnership is to be disregarded for this purpose.

Your committee agrees with the House that it would be undesirable to impose the limitations at the partnership level since this would permit individual taxpayers to exceed a limitation set by the statute simply by forming a number of partnerships. Moreover, it would work out unfairly where a large number of partners share the same item. If the limits were imposed at both the partnership and partner levels, they would discriminate against the partnership form of business. It is believed that the limits set in the code generally are the amount intended to be allowed to any single individual taxpayer. Your committee takes this view even though it recognizes that certain accounting complexities may arise when a partnership allocates items of income or deduction to partners differently situated. This amendment is intended to clarify, and not to change, present law. It should be made clear, however, that your committee does not consider that the word "limitation" as used in the amendment includes the restrictions on the choice of depreciation methods under section 167.

5. Section 702(e). Election for simplified reporting (new subsection)

As indicated in the discussion on the preceding subsections of section 702, the character of every partnership item of income, gain, loss, deduction, or credit of a partnership which has tax significance is to carry through to the partner and is to be reported separately by him on his own income tax return. For the medium-sized or relatively large partnership such exactness will, of course, be desired on the part of the taxpayers, since most of the special characteristics of various items will be advantageous to the partners in the computation of their own income tax liability. However, for a relatively small partnership, if most of its income represents ordinary income, maintaining the special character of various items frequently is of little benefit and adds considerably to the complexity of the computation for the partner in his own individual income tax return.

To avoid this result both the House and your committee's versions of the bill add a new subsection (e) to section 702 providing that a partnership may elect (where all of the members are individuals) to take all items of income and deduction into account as a single, net, ordinary income or loss item, with the exception of capital gain and loss items and dividend income. The capital gain and loss items will continue to be separated into gains and losses from the sale or exchange of capital assets held for not more than 6 months, gains and losses from the sale or exchange of such assets held for more than 6 months, and gains and losses from the sale or exchange of section 1231 assets. The separate reporting of these items is necessary to prevent tax avoidance possibilities where there are net losses. Dividend income under this election would also continue to be reported separately because such income must be identified separately for self-employment tax purposes.

To maintain this option as a simple method for reporting partnership income it is necessary to deny deductions and exclusions for this purpose where there is some fixed amount or percentage limitation. Also disallowed are any credits (other than those for dividends) attributable to the partnership income. The denial of these items in this case is necessary since otherwise such items would have to be determined separately at the partner level.

The election under this section can be made annually. Under the House bill this election had to be made not later than the time prescribed by law for filing the partnership return (including extensions of time for filing the return) for the year in question. It was pointed out to your committee in its hearings that since an election to use the simplified reporting in some cases will result in the denial of tax benefits otherwise available, this election can act as a "trap for the unwary." To minimize this result your committee has amended the House bill to provide that the election with respect to simplified reporting may be made or revoked for a partnership taxable year at any time before the expiration of 3 years from the date prescribed by law by which the partnership return must be filed (without regard to any extensions of time). This will mean a partnership will be able to change its election with respect to simplified reporting in the same period in which it generally will be possible to make additional assessments with respect to the taxes of the partners involved.

6. Section 703(b). Organizational expenditures (new subsection in House bill; deleted by your committee)

The House bill would have added a new subsection to section 703 providing that organizational expenses in the case of a partnership may be deducted ratably over a period of 60 months beginning with the month in which the expenses are paid or accrued. Under the House bill these expenses are defined as those incident to the creation of a partnership or to the preparation of the first written partnership agreement. The House provision was not to include any revision of, or substitute for, an already existing partnership agreement. In addition, these expenses were not to include expenditures incurred in order to obtain capital contributions for the partnership or those incident to the transfer of assets to a partnership.

Testimony before your committee has indicated that the lines of demarcation which the House bill would have provided as to which expenses may be treated as organizational expenses and which may not would lead to numerous difficulties. It was suggested, for example, that it would be difficult to distinguish between those expenses incurred in order to organize the partnership and those incurred in order to obtain capital contributions. It also was suggested that it would be arbitrary to distinguish between expenditures incurred with respect to the first version of a partnership agreement and not to allow a similar writeoff with respect to revisions of such an agreement. In view of these considerations, your committee decided to delete the organizational expense provision reserving it for future consideration. In doing this, it does not intend to affect the tax treatment now applicable with respect to such expenses.

7. Section 705 and section 763. Determination of basis of partner's interest (present sec. 705 (a) and (b))

Section 705 of present law provides two rules, a general rule and an alternative rule, for purposes of determining the basis of a partner's interest in a partnership.

The general rule requires a partner to determine the adjusted basis of his interest by taking the basis of the property originally contributed to the partnership, or the basis of the interest at the time of purchase, and then increasing this by the partner's distributive share of the income of the partnership and decreasing it by the partnership basis of assets distributed to him, and by the partner's distributive share of losses of the partnership.

The alternative rule provides that the Secretary or his delegate may prescribe the conditions under which the adjusted basis of a partner's interest may be determined by reference to what his proportionate share of the adjusted basis of partnership property would be if the partnership were to be terminated at that time.

Since the partnership frequently has to determine the adjusted basis of partnership property, your committee agrees with the House that the alternative rule, where the Secretary permits its use, is much simpler to apply than the general rule. Moreover, in the case of the simple partnership, where the contributions and distributions have been in money and there have been few if any transfers of partnership interests, the basis for a partner's interest reached under either rule is likely to be substantially the same.

In view of these considerations, both the House and your committee's bill provide that what is now the alternative rule, with modifications, is to become the general or standard rule, and that what is now the general rule is to become the alternative rule.

This new general rule will not apply, however, if the partnership elects the more detailed method (sec. 763 in the rearrangement). It also does not apply if a revenue agent upon examination of a partner's (or the partnership's) return (or subsequently in any process of review of a return) calls upon the partner to establish that there are no substantial differences (because of contributions, transfers of interests, or distributions) between computing the adjusted basis of his interest under the simpler procedure and computing it under the more detailed procedure provided in the new alternative section (sec. 763) and the partner fails to establish that there are no substantial differences. The House bill also provided that for the general rule to apply, the taxpayer upon request would have to establish not only that contributions, transfers or distributions did not create substantial differences between the two methods of computing the basis of an interest, but also that "other circumstances" did not create such differences. Your committee has deleted this reference to "other circumstances" because of the uncertainty that this would add to the provision. With a reference only to contributions, transfers and distributions it will be possible for a taxpayer to look at these three categories of transactions in determining whether there is a substantial difference under the two methods in computing the basis for his interest. If the reference to "other circumstances" were left in the bill, it would appear that all transactions, of whatever nature, would have to be examined. In determing whether a partner is to be permitted to use the new simpler, general rule or whether he must compute the basis of his interest under the more detailed rule, your committee intends that a factor to be taken into account is the difficulty involved in developing the transactions on which the more detailed rule should be based.

8. Section 706. Changing or adopting a taxable year

Section 706(b)(1) of present law would appear to require establishment to the satisfaction of the Secretary or his delegate of a business purpose before a partnership can adopt any year where its principal partners are on different taxable years. However, the regulations on this point provide that a newly formed partnership may adopt a calendar year as its taxable year without securing prior approval from the Commissioner if all of its principal partners are not on the same taxable year. Presumably the authority for this is contained in sections 441(b)(2) and 441(g)(3) of the code.

Section 706(b)(2) of present law would seem to indicate that a principal partner may change his taxable year to that of a partnership in which he is a principal partner without obtaining the consent of the Secretary or his delegate. However, the regulations on this section (sec. 1.706–1(b)(2)) indicate that a partner may not change his taxable year without securing prior approval from the Commissioner. This requirement is based on the fact that section 442 provides that if a taxpayer changes his annual accounting period the new accounting period is to become the taxpayer's taxable year only if the change is approved by the Secretary or his delegate.

Both the House and your committee's versions of the bill amend section 706(b)(1) clearly to permit a partnership to adopt the calendar year as its taxable year without the consent of the Secretary or his delegate where the principal partners have different taxable years. This is necessary because otherwise the partnership might find itself in the position of being unable to adopt any taxable year where the principal partners are on different taxable years. The rule in the regulations appears to be the most practical solution to this problem.

Both versions of the bill also amend section 706(b)(2) to make it clear that a partner must obtain the permission of the Commissioner to change his taxable year even though changing to the same year as that of a partnership in which he is a principal partner. It is believed desirable to make the rule in the present regulations the express statutory rule because there are many conditions under which the Secretary or his delegate might not want to permit a principal partner to change his taxable year to that of a partnership in which he is a member. For example, problems may arise where—

(1) an individual is a principal partner in more than one partnership;

(2) the income of the spouse of a partner, for some other reason, should be on a different taxable year; and

(3) the partnership income is only a minor portion of the taxpayer's total income.

9. Section 707. Transactions between partners and partnerships (present sec. 707 (a) and (c))

These are conforming changes.

10. Section 708(b)(1)(B). Termination of a partnership on sale to another partner of an interest of 50 percent or more

Present law provides that a partnership is to be considered as terminated if, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Thus, the sale of a partnership interest to another partner will terminate the partnership if the interest sold is 50 percent or more of the total interest in the partnership capital and profits. However, no termination occurs where a partner's interest is liquidated by making distributions to him of 50 percent or more of the partnership assets.

Your committee agrees with the House that this disparity in treatment between cases where an interest is sold and where a distribution is made places too much emphasis on form. For example, it would appear that the same result as the sale of an interest to other partners can be obtained by the partners intending to remain in a partnership making additional contributions of property to the partnership, and then the partnership making distributions to the withdrawing partner. In this case, of course, under present law (if these were not viewed as step transactions) there would not be a termination of the partnership even though the withdrawing partner had more than a 50-percent interest.

To equate the tax consequences in the sale and distribution cases, both the House and your committee's versions of the bill provide that a partnership is not to be terminated by a sale of an interest (regardless of the percentage interest sold) to partners who have been members of the partnership for at least 12 months prior to the sale.

The bill also makes it clear that the reference to sales or exchanges which result in a 50-percent change in interests (where the interests are sold to other than present members of the partnership) refers to the aggregate sales or exchanges occurring within a 12-month period.

11. Sections 721 and 722. Contributions to a partnership

The changes made in sections 721 and 722 are closely related to the changes made in section 770 and are included in the discussion on that section in No. 24 below.

12. Sections 731 and 732. Extent of recognition of gain or loss on distribution and basis of distributed property other than money

These are conforming changes.

13. Section 734. Basis of undistributed partnership property (present sec. 734(a))

These are conforming changes.

14. Section 735. Character of gain or loss in the case of sales or exchanges of distributed property (present sec. 735(a))

Present law provides that if a partnership distributes unrealized receivables or inventory items to a partner which he in turn sells, any gain realized by the distributee partner is to be ordinary income in the case of the inventory items, if they are sold within 5 years of the distribution, and in the case of unrealized receivables irrespective of how long after the distribution the sale occurs.

Both in the case of unrealized receivables and inventory items, present law refers to gain or loss "by a distributee partner." As a result, a distributee partner may be able to make a gift of the unrealized receivables or inventory items received by him, and his donee, upon the sale of the receivables or inventory items, may not be subject to the ordinary income treatment which would apply if the distributee partner had made the sale.

Your committee's bill provides that the character of a gain or loss on the sale of unrealized receivables or inventory items (actually "section 752 assets" under the bill, as explained subsequently) distributed to a partner is to be maintained through all subsequent transfers of the property where the basis of the distributee partner for the property is carried over to the transferee. This rule is consistent with the basic rules of present law and will prevent the avoidance of the ordinary income rule in the case of gifts of such property and in other cases involving the carryover of the distributee partner's basis.

Your committee's bill also removes the 5-year limitation presently applicable in the case of inventory items. As a result, unrealized receivables, inventory items, as well as other items classified as section 751 assets under the bill (defined in that section as shown below), when distributed are indefinitely to retain their ordinary income character in the hands of the distributee partner (or his transferee where the distributee partner's basis is carried over).

15. Section 736. Holding period for partnership property (present sec. 735(b))

This section involves only conforming changes.

16. Sections 741 and 743. Transfers of interests in a partnership (present secs. 741 and 743(a))

The House bill made only conforming changes in these sections. Your committee, however, has added a new subsection to section 741.

In most respects the partnership provisions attempt to provide substantially the same tax treatment for a partner who sells his interest as for one with respect to whom a distribution is made. This is intended to give assurance that mere differences in form will not result in substantive difference in taxation for partners. However, under present law even though there is no economic difference it is possible for partners to arrange different tax effects for the disposition of the interest of a retiring or deceased partner, merely by casting the transaction as a sale rather than a liquidating distribution. The generally applicable rule in such cases is contained in what was section 736 (sec. 776 under the rearrangement). This rule provides that amounts distributed in liquidation of an interest usually are to be classified as capital payments generally not taxable to the recipient (or deductible by the payors) unless there is a capital gain or loss realized. An exception to this rule, of course, is provided for payments for substantially appreciated ordinary income assets. Amounts paid in addition to these payments for the capital interest are considered as taxable income to the recipient and as deductible items to the payors. This latter category in all cases includes unrealized receivables. However, taxpayers have been able to obtain results which differ from those under this generally applicable rule by using "buy and sell agreements" effective at the time of a partner's retirement or death. These agreements usually provide for the purchase of the partnership interest of the retiring or deceased partner by the remaining partners on a pro rata basis (i.e., in accordance with their interests in profits or capital of the partnership). This has the effect of treating the entire amount received by the recipient as a capital transaction except to the extent substantially appreciated ordinary income assets are involved.

Your committee's amendments provide that these pro rata sales of interests to existing partners (or sales which are substantially pro rata) are to be treated as coming under section 776. Such sales of interests to the partnership are, of course, already treated as distributions to which section 776 applies. This will provide uniformity of treatment for these payments regardless of the form in which they are made.

17. Sections 749, 750, and 751. Collapsible partnership transactions (present sec. 751)

Under present law the so-called collapsible partnership provision applies both to sales of partnership interests and also to distributions by a partnership where there is a sale or distribution with respect to certain ordinary-income-type assets, and these assets represent a significant element in the transaction. The types of property with which this collapsible partnership provision is concerned are "unrealized receivables" and "inventory items which have substantially appreciated in value." The existing statute presents detailed definitions of unrealized receivables and inventory items. In addition, in the case of inventory items, two tests are applied in determining whether there is substantial appreciation and, therefore, whether or not the collapsible partnership provision applies. In all cases, however, the collapsible partnership provision applies in the case of unrealized receivables. For the gain attributable to the inventory items to be treated as ordinary income their fair market value must exceed 120 percent of their basis and also the fair market value of these assets must represent more than 10 percent of the fair market value of all partnership property other than money.

Both the House and your committee's bill have rearranged the present collapsible partnership provisions, which appear in section 751, by placing the portion relating to transfers of an interest in section 749 and the portion relating to distributions in section 750. The definitions, etc., remain in section 751. Most of the changes made by the House and your committee's version of the bill relate both to transfers of an interest and to distributions.

However, one change made in both versions of the bill applies exclusively to the sale of a partnership interest. This is the addition of the sentence in section 749 which provides that this section is to apply where there is a gain with respect to the ordinary income assets, whether or not there is an overall gain with respect to the sale or exchange of the interest. It is not clear under present law as to whether the ordinary income treatment applies only when there is an overall gain on the sale of an interest, or whether it applies where there is a gain on ordinary assets without regard to whether there is an overall gain or loss on the sale of the interest. Your committee agrees with the House that where there is ordinary income, the presence or absence of overall gain with respect to the entire interest should make no difference in the taxation of this ordinary income.

In section 750, which deals with distributions, both versions of the bill add an exception to the ordinary income treatment generally provided. The section 750 ordinary income treatment is not to apply in the case of a distribution of the partner's share of partnership income for the current year (including drawings and advances). This is an exception now set forth in the regulations and one which the House and your committee believe appropriately belongs in the statute. It is believed that this exception will do much to remove uncertainty as to the extent of the application of section 750.

The remaining changes made by the House and your committee apply both to sales of an interest and distributions. In the interest of simplification, both the House and your committee have substituted for the present troublesome definitions of unrealized receivables and inventory items a more general definition of items to which the ordinary income treatment is to apply. For convenience, the items in this category are referred to as "section 751 assets." These section 751 assets are in general defined as assets which, if held by an individual, would result in ordinary income upon their sale. This rule appears preferable to the separate definitions in existing law for unrealized receivables and inventory items because it provides the same rule for partnerships as is now followed by individuals. This also avoids problems in existing law in attempting to define what constitute unrealized receivables and particularly what constitute inventory items.

Both the House and your committee's versions of the bill make more equitable the application of the ordinary income treatment provided by the collapsible partnership provision by making available the offset of section 1231(b) losses. This is provided because other taxpayers may reduce ordinary income, with respect to which tax otherwise would be imposed, by any net loss on section 1231(b) assets (generally real and depreciable property used in the trade or business). Both versions of the bill, in order to provide as nearly as possible the same ordinary income treatment where a partnership interest is sold or a partnership makes a distribution as would apply in the case of other taxpayers, provide that the income treated as ordinary income is to be reduced by any loss referred to as a "section 751(b) loss." A section 751(b) loss is in general defined as any net loss which would occur as a result of the application of section 1231 with respect to partnership property which in effect the partner is selling. This may occur either because he is in effect selling such property when he sells his partnership interest or when, in a distribution, a distributee partner gives up an interest in such property or the partners remaining in the partnership after the distribution give up an interest in such property.

In determining whether the sale or exchange of an interest or a distribution of property will result in ordinary income, both versions of the bill provide that the character of the property is to be determined at the time of the sale or exchange or distribution. They also provide that the character is to be determined as if the property were sold directly by the person relinquishing the interest in the property. However, in this case, as in the case of the determination of the character of the income under section 702, due regard is to be given to any business, financial operation, or venture in which the partnership is engaged. Thus, the determination will be made separately with respect to each partner, but attention will be given to the fact that the partnership is acting for each of the partners. The discussion under section 702(b) is applicable here.

In addition, the two versions of the bill provide that the character of the property is to be determined as if all of the property had been sold to one person in one transaction. It is believed that this treatment is likely to conform with the facts in the situation where a partner is selling an interest or receiving a distribution, since in these cases he is in fact in a single transaction disposing of an interest in the property involved to one person or to a group of persons. For purposes of simplicity, all property of the partnership, in applying the ordinary income rule under the bill, is to be considered as if it had been held for more than 6 months (more than 12 months in the case of certain livestock described in section 1231(b)(3)).

The House bill makes three changes in the provision relating to the substantial appreciation test. Your committee's amendment accepts the changes made by the House but adds three other changes.

As previously indicated, under existing law "unrealized receivables" are treated as resulting in ordinary income in all cases, whereas inventory items are so treated only where there is "substantial appreciation." In the interest of simplification, the House bill, and also your committee's bill, applies this substantial appreciation test uniformly to all section 751 assets in the aggregate. Thus, ordinary income treatment will be applied in the case of "unrealized receivables" only when the appreciation in such items, together with the appreciation in inventory, etc., represents a substantial element in the sale or distribution transaction.

In determining whether there is substantial appreciation in the case of these section 751 assets, the House bill and also your committee's bill removes an unintended benefit in the present provision whereby real estate developers and others, through the use of liabilities (such as mortgaged property) may avoid the ordinary income treatment on what are in reality substantially appreciated section 751 assets. This avoidance is accomplished by reducing the section 751 assets below the specified percentage of the value of all assets by borrowing funds and purchasing additional nonsection 751 assets. The effect of this under present law may be to remove all of the section 751 assets involved from the category of "substantially appreciated." Both versions of the bill avoid this possible result by requiring that the fair market value of the partnership property (other than money), with which the value of the section 751 assets is compared, be reduced for any liabilities of the partnership.

Your committee has made three further modifications in the substantial appreciation test. First, it has raised the percentages to be applied under this test. Under present law for section 751 assets to be treated as substantially appreciated and as resulting in ordinary income, their fair market value must exceed 120 percent of their adjusted basis. Also, their fair market value must exceed 10 percent of the fair market value of all partnership property (other than money). Your committee's bill raises this 120-percent test to 125 percent and raises the 10-percent test to 15 percent.

In addition, your committee has amended the substantial appreciation test to provide that the test is not to apply unless the appreciation in the section 751 assets (that is, the excess of their fair market value over their adjusted basis) exceeds $1,000. This $1,000 de minimis rule under the bill is to be applied on an aggregate basis with respect to all of the assets considered as sold or exchanged, by any partner, or by the partnership, as the case may be, in all transactions in the 12-month period immediately before and also in the 12-month period immediately after the transaction in question.

Both of the amendments described above are designed to ease the application of the ordinary income test treatment provided by present law. Thus, ordinary income treatment will no longer apply where the gain involved is $1,000 or less or where the value of the property involved is within the range of 10 to 15 percent of the fair market value of all partnership property or where the appreciation in the value of these assets is within the range of 20 to 25 percent.

A third amendment added to the provision defining substantial appreciation is designed to prevent possible tax avoidance. Under present law it is possible to avoid the percentage tests specified in the statute by contributing property to the partnership, or by the partnership purchasing property. Thus, for example, ordinary income assets may be contributed to, or purchased by, the partnership in sufficient volume so that the unrealized appreciation in the ordinary income assets is not above 25 percent. Similarly, nonsection 751 assets can be contributed to, or purchased by, the partnership in sufficient volume so that the fair market value of the section 751 assets does not equal 15 percent of the partnership property (other than money and reduced by the liabilities of the partnership). To avoid these results your committee has added an amendment to the bill providing that assets contributed to, or otherwise acquired by, the partnership within the 12-month period immediately prior to the sale or exchange or distribution involved are not to be taken into account in applying the percentage tests unless there was a bona fide business purpose for the contribution of the property to the partnership or for the acquisition of the property by the partnership.

18. Section 761. Special rules for contributed property (present sec. 704(c) (2) and (3))

These are conforming changes.

19. Section 762. Family partnerships (present sec. 704(e))

These are conforming changes.

20. Section 763. Alternative rule for determination of basis of partner's interest (present sec. 705(a))

This provision was discussed in connection with section 705.

21. Section 764. Closing of a taxable year for deceased partner or partner who sells or exchanges part or all of interest (in part new and in part present sec. 706(c)(2))

Section 706(c)(2)(A)(ii) of present law provides that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year.

Present law provides that the partnership year is to remain open with respect to a partner who dies in order to prevent the "bunching" of more than 1 year's income for tax purposes in the year of death of a partner whose taxable year differs from that of his partnership. However, this overlooks the fact that where "bunching" is not a serious problem such treatment may deny the opportunity to offset this income against deductions and exemptions available in the year of death. It may also deny the benefits of income splitting with respect to this partnership income.

Your committee agrees with the House that in the usual case, where the partnership and the partners are on the same taxable year, it is more important in the case of a deceased partner to have the opportunity to offset the partnership income against deductions, exemptions, and other benefits available in the year of death than it is to avoid the "bunching" of income by reporting such income in the year after the death of the partner. Consequently, both the House and your committee's versions of the bill provide that as a general rule the partnership taxable year in the case of a deceased partner is to close at the date of death. However, the two versions of the bill provide that the successor in interest of a deceased partner is to have the option to continue the year with respect to the deceased partner to the normal ending of the partnership year, where there has been no sale, exchange, or liquidation of this interest before that date.

Where the interest has been sold, exchanged, or liquidated after the death of the deceased partner but before the end of the partnership year the House bill and your committee's amendments provide somewhat different results. Under the House bill the partnership year could not be continued beyond the time when any part of the deceased partner's interest was sold, exchanged, or reduced after his death. Under your committee's amendments the deceased partner's successor can elect to continue the year to the normal ending of the partnership year even though part of the interest involved has been sold or otherwise disposed of, so long as the entire interest is not disposed of. Where part of the deceased partner's interest is disposed of in the interval after the death and before the normal ending of the partnership year, the rules generally applicable in the case of the sale of part of an interest are to apply in determining a partner's distributive share of income.

Where there is an agreement to sell, exchange or liquidate a deceased partner's interest, operative on the date of death, his successor in interest is to have the option to continue the partnership taxable year for the decedent's interest until the day following the decedent's death. Under the House bill where part of an interest was sold, exchanged or reduced at death by such an agreement this same rule would have applied. This becomes unnecessary, however, under your committee's amendments. Since the sale, exchange, or reduction of part of an interest in the case of other than a deceased partner does not close the taxable year for such a partner, your committee saw no reason for applying a more restrictive rule closing the partnership year where part of an interest was sold, exchanged or liquidated in the case of a deceased partner.

22. Section 765. Certain sales or exchanges of property with respect to controlled partnerships (present sec. 707(b))

Section 707(a) of present law provides that as a general rule, if a partner engages in a transaction with a partnership, other than in his capacity as a member of the partnership, the transaction is to be considered as occurring between the partnership and one who is not a partner. Subsection (b), however, provides certain exceptions to this rule.

Under these exceptions losses are disallowed in the case of sales or exchanges of property between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in the partnership, and also in the case of two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

The exceptions also provide in certain cases that any gain recognized on the sale or exchange of property other than a capital asset is to be ordinary income. The transactions referred to are sales or exchanges between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interest, or profits interests, in the partnership or between two partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interests, or profits interests.

Under the rearrangement these limitations on the extent to which transactions between a partner and a partnership are to be treated in the same manner as transactions between unrelated parties are set forth in section 765. In addition, the House bill makes a series of changes designed to perfect these exceptions. Your committee has accepted these changes with two modifications referred to below.

First, in the case of both the gain and loss provisions, both versions of the bill change the references to transactions between a "partner" and a partnership to transactions between a "person" and a partnership. This is designed to make it clear that a loss may be disallowed, or a gain taxed as ordinary income, even though the person making the sale is not a partner but instead is a person closely related to a partner.

Second, both versions of the bill delete the words "directly or indirectly", in both the gain and loss provisions, from the reference to ownership between a person and a partnership as being unnecessary in view of the specific constructive ownership rules applicable in these cases. It also removes this phrase in the case of ownership between two partnerships, in both the gain and loss provisions, for the same reasons.

Third, the two versions of the bill expand the loss provision to cover losses which may arise in the case of sales or exchanges between a partnership and a corporation, or trust, or estate where there is ownership of common interests of more than 50 percent. They also provide that this is to be the exclusive rule in the case of transactions between partnerships and corporations or estates or trusts. This removes an overlap which currently exists between section 267 and section 707(b)(1).

Fourth, both the House and your committee's bill make the ordinary income treatment inapplicable in the case of gains where the transfer involves land used in a trade or business. The exclusion presently applies only in the case of capital assets. Capital assets, under present law, are excluded from the application of the ordinary income treatment, in the case of controlled partnerships, since such assets, whether in the hands of the partnership or the partner, can result only in capital gain or loss. Since this is also true in the case of land used in a trade or business (and since this does not result in depreciation deductible against ordinary income) your committee agrees with the House that it is appropriate to extend this same rule in such a case.

Fifth, both in applying the 50-percent test in the case of losses and the 80-percent test in the case of gains, the two versions of the bill use the term "common interests." This term "common interests" is determined with respect to two or more persons by adding together the smaller interest which each such person has in both of the organizations in question. In other words, the common interests are the sum of these smaller interests. This rule can be illustrated by the case where partners A and B share the ownership of one partnership on a 10- to 90-percent basis and of another partnership on a 90- to 10-percent basis. In this case the "common" ownership of A in the two partnerships would be 10 percent. The "common" ownership of B also would be 10 percent with the result that the total common interests owned by the two partners in each partnership would be 20 percent. Under present law, merely because both A and B are members of both partnerships, and together own more than a 50-percent interest in each partnership, a loss resulting from the sale of property between these two partnerships would be ignored. This appears inappropriate since in reality a sale between these two partnerships represents a shift in equity ownership between A and B to the extent of 80 percent. Your committee agrees with the House that the new "common interests" rule is desirable both in that it is more specific and more equitable than the rules followed under present law.

In the House committee report it was stated that the common interest in two or more organizations for one individual was to be the smaller (or smallest) common interest he had in the organizations. Your committee agrees with this result but upon examination of the statutory language in the House bill decided that a modification was necessary to obtain the result intended by the House. Therefore, one of its modifications in this provision is to obtain this result. Thus, if A has a 30-percent interest in one organization and a 50-percent interest in another organization, his "common interest" in the two organizations under the bill as modified by your committee will be 30 percent.

The other modification made by your committee in this provision relates to gains treated as ordinary income. Here, as was already provided under the House bill in the case of losses, your committee has made it clear that the sale or exchange referred to was not only between an individual and a partnership or between two partnerships where the 80-percent test was met but also between a partnership and a corporation or between a partnership and a trust or estate where this 80-percent test was met. Since the House bill already included transactions between a "person" and a partnership, the cases specifically covered by your committee's modification may already have been covered by the House bill. However, the modification made by your committee clarifies this point.

23. Section 766. Continuing partnership in mergers or consolidations and divisions (present sec. 708(b)(2))

These are conforming changes.

24. Section 770. Interest in partnership capital exchanged for services (new section)

Present law provides that no gain or loss is to be recognized to a partnership or to any of the partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, the regulations (sec. 1.721-1(b)(1)) state that this provision does not apply to the extent a partner gives up a part of his capital interest as compensation for services rendered by another person. In such a case the regulations provide that the value of the interest transferred is income to the person performing the services. They also provide that the amount of the income in this case is the fair market value of the interest transferred at the time of the transfer in the case of past services, or otherwise at the time the services are rendered.

Both the House and your committee in general approve of the result obtained in the regulations but believe that there should be a clear statutory basis for this position. Moreover, valuation at the time the services are completed does not appear to give a satisfactory result in the case of services to be rendered in the future since the valuation at this future date might include a substantial amount of appreciation which occurred after the transfer of the interest. This appreciation (except in the case of inventory, etc.) should be capital gain rather than ordinary income.

Both the House and your committee's versions of the bill recognize ordinary income in the case of the service partner and treat this amount taxed to him as a contribution by him to the partnership. This will also result in an increase in the basis of partnership properties to the extent the value of the interest given to the service partner exceeds its basis, except to the extent this appreciation is attributable to section 751 assets (as is explained below, this is not initially taxed to the service partner) and except to the extent the partnership otherwise is given a basis adjustment for amounts chargeable to capital account.

In the case of the already existing partners the partnership is allowed a deduction, if the services performed by the service partner for the partnership are of such a nature as to constitute a trade or business expense, and this deduction then is allocated among the already existing partners (or their successors). On the other hand, if the services performed by the service partner are of such a nature as to give rise to capital values in the partnership, rather than representing a trade or business expense, then the basis of partnership properties is increased by an amount representing the services. In order to avoid a complex set of rules, the partners relinquishing the interests in the capital of the partnership do not recognize any gain or loss with respect to this relinquishment. Because of this, the deductions which they may receive (where the services take the form of a trade or business expense) are limited to their adjusted basis for the interest being relinquished.

Both the House and your committee's versions of the bill provide generally that the amount to be included for tax purposes in the gross income of the partner performing the services is to be the same as the deduction which is available through the partnership to the existing partners (subject to the basis limitation referred to above) or the addition to the basis of partnership properties, as the case may be.

Your committee with one modification has adopted the rules provided by the House bill for determining the amount to be taxed to the service partner and deducted (if not resulting in a capital item) by the other partners. This modification reduces the amount otherwise taken into account by the amount of unrealized appreciation in section 751 assets represented in the interest transferred to the service partner. This will prevent the service partner from being taxed twice with respect to these ordinary income items, once when the service partner receives his interest and again when the partnership realizes the income. Thus, to the extent the partnership will subsequently realize income with respect to section 751 assets the service partner will not be required to take up as income under section 770 the value of the interest he receives.

Where the interest in the partnership is transferred to the service partner without any substantial restrictions or limitations as to its transferability, the House bill provided that the amount is to be taken into account at the time of the exchange (for all of the purposes referred to above) and is to be the fair market value of the interest at that time. Your committee has accepted this rule except for the reduction referred to above for any unrealized appreciation in section 751 assets.

Where the interest is subject to substantial restrictions or limitations as to transferability at the time of the exchange, the House bill provides that the amount is to be taken into account at the time these restrictions or limitations cease to be substantial (or the interest is disposed of other than by death where the restrictions or limitations continue). The amount to be taken into account at that time is to be the smaller of the fair market value of the services or the fair market value the interest would have had at the time of the exchange had there been no such restrictions or limitations. Your committee has accepted these rules also, except for the reduction referred to above with respect to section 751 assets. These rules give assurance that appreciation in value of capital assets, subsequent to the transfer of the interest, will not be taken into account as ordinary income to the service partner. As already indicated, this amount which is taken into account is the same for the service partner with respect to his inclusion in gross income and for the partnership where the services performed result in an increase in partnership capital value. However, where the services result in a trade or business expense deduction to the partnership then the amounts taken into account as deductions by the existing partners are to be the amount already referred to, or, if smaller, the adjusted basis of the interests in the partnership which such partners relinquish to the service partner. Since such partners do not have to recognize the capital gain currently in such a case, it was thought appropriate to limit the deduction to the basis of the interest relinquished.

25. Section 776. Amounts paid to a retiring partner or a deceased partner's successor in interest (present sec. 736)

Present law provides that when amounts are paid to a retiring partner, or successor in interest of a deceased partner, in liquidation of a partnership interest the amount is subject to the ordinary distribution rules to the extent it is in exchange for the partner's share of partnership property. However, amounts paid in excess of the fair market value of the deceased or retiring partner's share of the property are treated as a distributive share of partnership income or as a guaranteed payment. There are two exceptions, however, to these general rules. First, a payment for unrealized receivables of the partnership is always treated as ordinary income rather than as a distribution. Second, a payment in exchange for the retiring partner's or successor's interest in goodwill of the partnership is not considered to be a distribution unless the partnership agreement at the time of death so provides.

The bill, both as passed by the House and as reported by your committee, retains the basic division of payments coming under this section between those classified as ordinary income payments in subsection (a) and those treated as distributions with respect to an interest under subsection (b). However, a number of rules to make the application of this provision more specific have been added by the House and accepted by your committee.

First, the bill clarifies the time of taking the ordinary income subsection (a) payments into account. Under the bill the subsection (a) payments generally are to be taken into account as of the last day of the taxable year of the partnership in which they are paid or become payable. However, where the amounts become payable either within the partnership year with respect to which they are determined, or by April 15 of the following year in the case of a calendar-year partnership (or corresponding period for other partnerships), under the bill they are to be taken into account as of the end of the year with respect to which they are determined. Generally it is believed that it is reasonable to take these amounts into account when they are paid (or become payable in the case of accrual-method taxpayers). However, when they are paid either in or shortly after the year with respect to which they are determined, it is believed that the partners probably intended the amounts to be considered as a distributive share and, therefore, that the income in these cases should be reported as a part of the income of the year with respect to which the amounts were determined.

Second, the bill provides that these amounts which are taken into account at some time after the year with respect to which they are determined are always to be classified as "guaranteed payments" and never as "distributive shares." The effect of this is that in such cases the special characteristics of partnership income will not be carried over to the retired partner or heir. Your committee agrees with the House that to treat these payments as distributive shares, retaining all of their special income characteristics, would present a practical administrative problem to the partnerships of having initially to make one distribution of partnership income with respect to a year and then subsequently, perhaps many years later when the amounts are paid, having to make a redistribution of the earlier year's income on a different basis, including an accounting for all of the special income characteristics of that earlier year on a new basis.

Third, the bill provides a new special definition of unrealized receivables for purposes of section 776 (and also sec. 691). As indicated previously, for purposes of most of the partnership provisions, unrealized receivables, inventory items, and other ordinary income items, have been combined into a single category known as section 751 assets. However, in the case of retiring or deceased partners, only payments with respect to unrealized receivables have been placed in the category of subsection (a) amounts. Therefore, in view of the removal of the definition of unrealized receivables for other purposes, it was necessary to provide a special definition of unrealized receivables for purposes of this section. The definition of unrealized receivables added by the bill in section 776 is similar to the definition in section 751 of existing law. However, the bill limits the application of the definition in the case of services to be rendered or goods to be produced. Services not yet performed are omitted from the definition. In the case of goods, those not yet delivered, where a partnership is predominately in a distributing trade or business, also are omitted. For manufacturing and similar types of business, the term includes goods produced, but not yet delivered, where orders have been placed at the time of the withdrawal from the partnership of the deceased or retiring partner.

Fourth, the bill provides that where all of the payments with respect to a partnership interest are made within a 12-month period, the entire amount is to be treated as coming under the distribution rules with no part being classified as a section 776(a) amount. Under present law, problems have arisen where partnership agreements have provided for a single payment (or perhaps two or three payments within a short period) in liquidation of the interest of a retiring or deceased partner. In such cases it is likely that the partners set up such a transaction in the expectation that the distribution rules would apply. However, if upon audit the payments made in liquidation of the interest are determined to be in excess of the fair market value of the interest in partnership property being liquidated, it can be contended that part of this payment is required to be classified as a subsection (a) payment. This is true even though this was not the intention of the partners and will result in substantially different tax treatment for the remaining partners and retiring partner (or successor in interest of the deceased partner) than was contemplated. Your committee agrees with the House that when the agreement provides for a single payment, or several payments within a short period, the parties ordinarily do not intend the payments to represent a share of partnership income, mutual insurance or similar payments. Therefore, in the bill a rule is added which provides that where all of the amounts in liquidation of the interest of a retiring or deceased partner are payable within a 12-month period, this entire amount is to be treated as a distribution by the partnership. Of course, the collapsible partnership provisions will apply to such a distribution under the bill in the same manner as in the case of other distributions.

Fifth, where a distribution with respect to a retiring or deceased partner includes both money and other property, the bill provides that the money is first to be considered as a subsection (a) amount, with the other property generally being classified as the subsection (b) amount. In cases where the payments are made both in money and in other property, problems have arisen under present law as to whether the money is to be considered as the ordinary income amount and the other property as the distribution, or vice versa, or whether the money and other property are to be allocated pro rata under the ordinary income and distribution provisions. In the interest of simplicity and certainty the rule provided in the bill is that any money received by the recipient is first to be considered as a subsection (a) amount and that only any excess of the money over this amount is to be classified as coming under subsection (b).

Sixth, the bill also provides a special rule to deal with certain cases where payments which have been treated as section 776(a) payments are continued after the partnership in question goes out of existence. Present law does not indicate the treatment to be available in such cases. Your committee agrees with the House that at least from the standpoint of the recipient of the ordinary income amount, there is no reason to change the income classification of such a payment merely because the remaining business organization has changed its form. Thus, the bill provides that the ordinary income treatment is to continue for the recipients of these payments so long as they are continued, regardless of the form of business organization which makes the payments. Under the bill these amounts are treated as guaranteed payments to avoid the problem of attempting to carry through any special characteristics the income may have in the hands of a successor organition. The bill also provides that if the person making the payment is an individual who was a partner before the retirement or death, is under a legally binding obligation to make the payment, and is operating a trade or business as sole proprietor, then this individual is to be entitled to deduct the amount of these subsection (a) payments as a trade or business expense deduction. Thus, in the case of the payer, deductions will still be available even though the partnership no longer exists where the business is carried on by the remaining partner. This makes provision for the two-man partnerships where one of the partners retires or dies.

26. Sections 691, 777, and 1014(c). Income in respect of decedent and property acquired from a decedent (present sec. 753)

Present law provides that amounts includible in gross income of an heir of a deceased partner as ordinary income, under what in this bill is section 776(a), are to be considered income in respect of a decedent under section 691. Thus, the discounted value of these amounts are includible in the gross estate of the decedent partner for estate tax purposes; then subsequently, when such amounts are paid, the recipient is subject to ordinary income tax and obtains no basis with respect to such amounts as a result of the transfer at the decedent's death. However, to mitigate the effect of imposing both an estate tax and an income tax with respect to the same amount, a deduction presently is available to the recipient of these payments equal to the portion of the estate tax paid which was attributable to them. In addition, while the present section 753 makes no specific mention of the treatment of the decedent's distributive share for the portion of the partnership year up to the date of his death, including any part of this share which the decedent may have withdrawn before death, the regulations (sec. 1.753-1(b)) make it clear that such income is subject to section 691 treatment.

Both the House and your committee's versions of the bill transfer section 753 of existing law to section 691, since this latter section is the general section concerned with "income in respect of a decedent." In addition to providing, as does existing law, that section 736(a) amounts (sec. 776(a) amounts under the bill) includible in the gross income of a successor in interest of a deceased partner are to be considered as income in respect of a decedent, the House bill adds three other categories to "income in respect of a decedent." Your committee has accepted these changes although it has provided a modification to give assurance that a basis adjustment will not be lost as the result of the operation of these new provisions.

First, both the House bill and your committee's amendments provide that income in respect of a decedent treatment is to apply to the distributive share of income attributable to the part of the year occurring prior to a deceased partner's death. Second, both versions of the bill provide that amounts attributable to unrealized receivables, not already treated as income in respect of a decedent as a result of the application of section 776(a), are to be so classified. Third, both versions provide that the amount required to be taken into account in income by a service partner as a result of the exchange of an interest in capital of a partnership for his services is to be treated as income in respect of a decedent if the interest is acquired by a successor in interest by reason of death and the restrictions or limitations continued beyond the date of death. The successor reports this income for income tax purposes (and takes the deduction for the estate tax) when the restrictions or limitations cease to be substantial or the interest is transferred, whichever occurs first.

An amendment is also made to section 1014(c) of existing law which relates to the basis of property acquired from a decedent. The House bill amended this provision to provide that there is to be no change in basis of property as a result of death for the portion of the value of an interest in a partnership attributable to property which represents a right to receive income in respect of a decedent under section 691. Your committee has accepted the House provision although it has modified it in one respect. It has provided that nothing in this provision is to deny an increase in the basis of the interest in a partnership of a deceased partner to the extent that this basis increase is attributable to his distributive share of items of income and gain in the last year before his death, to the extent that this income remains in the partnership at the time of the death of the partner. Generally a partner receives an increase in the basis of his interest in the partnership with respect to his share of the income of a year at the time this income becomes taxable to him. However, income for the partial year prior to death in the case of a deceased partner is reported as income by his successor in interest who was not the partner with respect to the portion of the year to which this income was attributable. Therefore, the regular basis provisions for a partnership interest may not provide for an increase in this case. Moreover, since the income is "income in respect of a decedent," there generally would be no increase in basis with respect to this portion of the value of the interest at the time of the decedent partner's death. The amendment made by your committee makes up for this possible absence of an appropriate basis adjustment for the interest of the deceased partner by permitting an increase in basis at death in this case even though the income is "income in respect of a decedent" for other purposes.

Under the bill, section 777 makes specific references to the provisions referred to above, in order to give as complete as possible a presentation of partnership provisions in subchapter K. However, the provisions referred to above are in sections 202 and 203 of the bill.

27. Section 780. Manner of electing optional adjustments to basis of partnership property (present sec. 754)

Present law in section 754 indicates the manner in which an election may be made to establish a special partnership basis for property in the case of a partner who acquired his interest by transfer. It also indicates the manner in which an election may be made for adjustments to partnership property as the result of a distribution of property to a partner where the property takes a different basis in the hands of the distributee than it had in the hands of the partnership, or where gain is recognized to the distributee. At present if a partnership elects to make the adjustments with respect to a transferee partner it must also elect to make the adjustments with respect to distributions, and vice versa. Once such election is made it generally applies to all subsequent distributions and transfers.

Both the House and your committee's versions of the bill provide that the elections with respect to distributions provided by section 781 (sec. 734(b) under present law) and with respect to transferee partners provided in section 782 (sec. 743(b) of present law) are to be separate elections. Your committee agrees with the House that these elections should be separate because it does not see why, if a partnership desires to make adjustments with respect to transfers in the case of special transferee partners, it should also be required to make adjustments generally with respect to distributions, or vice versa. It is believed, for example, that frequently a partnership may want to give transferee partners the advantage of a new basis because this new basis is of importance to the transferees, yet be reluctant to make what may be minor adjustments to the basis of property in the case of all distributions. On the other hand, the adjustments resulting from distributions may be the main concern of the partnership. Therefore, both versions of the bill provide that these two types of elections are to be separate elections.

The regulations under existing law provide that the election under section 754 must be made in a written statement filed with the partnership return to which the election applies. Your committee agrees with the House that this is too restrictive and that the partnership should be given until 1 year after the date prescribed by law for the filing of the return (without regard to extensions of time) for the filing or changing of the elections under section 780, and has, therefore, added a sentence to section 780 so providing.

28. Section 781. Optional adjustment to basis of undistributed partnership property (present sec. 734(b))

Section 734(a) of present law provides that the basis of partnership property is not to be adjusted as the result of a distribution of property to a partner unless the partnership has so elected. Subsection (b) (sec. 781(a) in the bill) relates to the method of adjustment where such an election has been made. Paragraph (1) of this subsection provides that the basis of partnership property is to be increased by any gain recognized to the distributee partner, and also where the distributed property had an adjusted basis to the partnership in excess of the basis attributed to the property in the hands of the distributee. Paragraph (2) of subsection (b) provides for decreases in the adjusted basis of partnership property in the reverse situations.

The House bill makes two changes in this provision, both of which are agreed to by your committee. First, it provides that the method of making the adjustments to remaining partnership property, after a distribution to a partner is made, is to be changed to reflect the difference between the basis to the partnership of the distributed property and the reduction which occurs in the distributee partner's proportionate share of the adjusted basis of the partnership property. Second, the bill provides a de minimis rule, whereby even though a partnership has elected to make the adjustments to the basis of partnership assets, it may not make these adjustments where their total amount (either an increase or a decrease) with respect to a distribution is less than $1,000.

The rules contained in section 781(a) are intended to provide a partnership with the option to maintain the same adjusted basis for partnership property in the aggregate, as is represented by the aggregate of the adjusted basis of all of the partnership interests. However, this relationship may already have been distorted before the partnership made the election to apply section 781(a). As a result, the rule of present law which determines the adjustments to be made by the partnership on the basis of whether or not gain is recognized to the distributee partner or upon the excess of the partnership basis for the distributed property over the basis to the distributee for this property, means that an accurate result is reached only if the partnership had made this election with respect to all prior transactions in which the partnership was involved. A more accurate result where this election had not been made with respect to all prior transactions can be obtained by making the adjustment on the basis of the partner's proportionate share of the adjusted basis of the partnership property. In addition, this will conform the operation of section 781 with the similar provision in section 782 which deals with the adjustment to the basis of partnership property following the transfer of a partnership interest.

The problem can be illustrated by an example. Assume that the assets of the equal partnership ABD had a partnership basis of $9,000 and a fair market value of $15,000. D, who recently purchased his interest in the partnership from C for $5,000, has a $5,000 basis for his interest. A and B each has a basis for his partnership interest of $3,000. Under existing law if a $5,000 cash distribution is made by the partnership to either A or B in liquidation of his interest, the partnership would be entitled to an upward adjustment of $2,000 to the basis of remaining partnership assets. However, a similar distribution to D would result in no adjustment. Under the amendment made by the bill there would be a $2,000 adjustment regardless of which partner received the distribution. This seems appropriate since the economic effect upon the partnership is the same in each case.

The $1,000 de minimis rule has been added as a simplification measure. Requiring partnerships to ignore small adjustments of this type will make it possible to limit the actual adjustments made to those where they are significant items for the partnership.

29. Section 782. Optional adjustment in the case of transfer of an interest (present sec. 743(b))

Present law provides that as a general rule the basis of partnership assets is not to be changed as the result of the transfer of a partnership interest by a sale or exchange or on the death of a partner. However, section 743(b) of present law (sec. 782 under bill) provides that in these cases the partnership may elect to make an adjustment to the basis of partnership properties for purposes of the transferee partner. If a partnership elects to make this adjustment to the basis of partnership property, this election is binding with respect to all future transfers, and distributions as well, unless permission for revocation is received from the Secretary or his delegate.

The House bill provided that a de minimis rule is to be added to the optional adjustment for transfers and this change has been accepted by your committee. The rule provides that even though a partnership has elected to make the adjustment to partnership basis for transferees, it may not make this adjustment where the total adjustment with respect to a transfer is less than $1,000. This change has been made in the interest of simplification. Ignoring these small adjustments will make it possible to hold the adjustments actually made, and the work entailed for the partnerships, to those cases where the adjustments are significant factors for the transferee partners.

30. Section 783. Allocation of basis for optional adjustments (present sec. 755)

Section 755 of present law (sec. 783 of the bill) contains the allocation rules which must be followed by a partnership in allocating basis among various partnership properties where either a transfer has occured and an adjustment is required with respect to the transferee partner in the manner provided in section 782 (under the bill), or a distribution has been made by the partnership and an adjustment is required to the basis of partnership property in the manner provided in section 781 (under the bill). The general rule contained in subsection (a) provides that basis is to be allocated among the partnership properties in a manner which reduces the difference between their fair market value and their adjusted bases. However, partnerships are also permitted to allocate the basis to partnership properties in any other manner permitted by regulations. Subsection (b), however, imposes certain limitations on the allocation rules set forth in subsection (a). It requires the allocation rules to be applied separately between capital assets and trade or business properties on one hand and other property on the other hand. Thus, property distributed or interests transferred which give rise to a basis adjustment which fall in one of these two categories must be allocated to partnership property falling in the same category. The special allocation rules also provide that the basis of any partnership property may not be reduced below zero. They further provide that in the case of a distribution where adjustment to basis of property is prevented by the absence of such property on the part of the partnership, or an insufficient adjusted basis, the adjustments are to be held in abeyance and then applied to subsequently acquired property.

The House bill makes two substantive changes in these allocation rules, both of which your committee has accepted. First, in the case of transfers of interests it removes the requirement of the present law that adjustments to basis of partnership property must be made separately for capital assets and depreciable property on one hand and other property on the other hand. It retains this rule, however, in the case of distributions. It also adds to the statute the rule set forth in the regulations to the effect that no basis may be allocated to assets where their adjusted basis is equal to or exceeds their fair market value.

The requirements of present law that adjustments to the basis of partnership property must be made separately for capital assets and depreciable property on one hand and other property on the other hand were directed primarily toward the adjustment to the basis of partnership property after a distribution has been made. For example, a partnership having only capital assets and inventory, might distribute the capital assets which in the hands of the distributee partner would take a lower basis than they had in the hands of the partnership. If it were not for the rule requiring separate allocations of basis for capital assets and depreciable property on one hand and all other property on the other hand, it would be possible as a result of this distribution for the partnership to increase the basis of inventory as a result of adjustments attributable to capital assets. Thus, it could shift income from the ordinary income category to the capital gain category. This problem does not exist, however, in the case of special bases for partnership assets for transferees. In such cases, because there are no assets being distributed, the assets which give rise to the additional basis on the transfer of the partnership interest remain in the partnership after the transfer. Moreover, in this case the general rule which requires the allocation of basis according to the difference between the basis of partnership assets and their fair market value, gives assurance that the additional basis will be assigned to the assets which account for the additional fair market value at the time of the transfer, whether the assets are capital assets or inventory items. As a result, in the interest of simplification the two-category allocation rules have been deleted with respect to special adjustments to partnership assets for transferee partners.

Your committee also agrees with the House that the rule in the regulations to the effect that no basis should be allocated to assets above their fair market value is an appropriate rule and, therefore, has also agreed to its inclusion in the statute.

31. Section 784. Special basis to transferee upon subsequent distribution (present sec. 732(d))

These are conforming changes.

32. Section 785. Special basis to transferee upon subsequent sale or exchange (new section)

Where a partner acquires his interest in a partnership by purchase or by inheritance, but the partnership does not make the section 754 election which would give him a special transferee basis with respect to any increase in value of his interest over its basis in the hands of the former partner, present law provides that, if a distribution with respect to this interest is made to him within 2 years of its acquisition, he may treat the interest at the time of the distribution as if it had a special partnership transferee basis. No such rule is available under present law, however, where after an individual acquires an interest by purchase or inheritance he sells or exchanges this interest within 2 years of its acquisition.

The House bill adds a new section 785 which in effect provides the same treatment in these cases where a partner sells an interest within 2 years of its acquisition as is presently available in similar situations where a distribution is made within 2 years (see sec. 784). Your committee has accepted this provision because it sees no reason to distinguish in this respect between distributions and sales of interests. This rule is important in the case of the sale of an interest where there has been an increase in the basis of the interest which is attributable to inventory. In such a case the additional basis for the inventory upon a subsequent sale or exchange of the interest can be allocated to these assets under section 785 and in this manner prevent the realization under section 749 of ordinary income a second time with respect to the inventory.

33. Section 788. Exclusion of certain organizations from partnership provisions (present sec. 761)

Present law creates two special categories of organizations which are permitted to be excluded from the application of all or part of subchapter K if all of the members so elect and if the income of such members can be adequately determined without the computation of partnership taxable income. These are organizations set up for investment purposes only, or for the purpose of jointly producing, extracting, or using property, but not for its sale.

The requirement of present law that the organizations can be excluded from subchapter K only if the election is made by all of the members creates serious practical difficulties. Your committee agrees with the House that this problem can best be avoided by permitting the organization itself to file the election as to whether or not it will be excluded from the application of all or part of subchapter K. Thus the problem of obtaining the consent of all of the members, some of

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whom may in fact not even be known to the organization, is avoided by having the organization itself make the election. A new election will not be required under this provision if an effective election has been made under present law.

34. Section 204 of bill. Effective dates

Generally, the partnership provisions are made applicable to any partnership taxable year beginning on or after the date of enactment of this bill and with respect to any part of a partner's taxable year falling within such a partnership taxable year. Certain special effective dates, however, are provided under both the House and your committee's versions of the bill in the five following cases:

(1) Section 735, which relates to the character of gain or loss on the disposition of distributed section 751 assets, is to apply only if the distribution by the partnership took place in a partnership taxable year beginning on or after the date of enactment of this bill (without regard to the date on which the distributee may dispose of the assets).

(2) Section 764, relating to the closing of a partnership taxable year for deceased partners or partners who sell or exchange part or all of their interests, is to apply only if the partners die, or sell or exchange part or all of their interest, on or after January 1, 1960.

(3) Section 765, relating to certain sales or exchanges of property with respect to controlled partnerships, is to apply only if the loss or gain to which the section relates arose from a sale or exchange occurring after the date of enactment of this bill.

(4) Section 770, relating to an interest in partnership capital exchanged for services, is to apply only with respect to exchanges occurring during a partnership taxable year beginning on or after the date of enactment of this bill.

(5) Section 776, relating to amounts paid to a retired partner or a deceased partner's successor in interest, is to apply only with respect to partners who die or retire during a partnership taxable year beginning on or after the date of enactment of this bill.

The amendments made to sections 691 and 1014 of the code, dealing with income in respect of a decedent and basis in the case of property received from a decedent, under both versions of the bill are to apply only with respect to decedents dying in a partnership taxable year beginning on or after the date of enactment of the bill.

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B. TECHNICAL EXPLANATION OF TITLE II—PARTNERS AND PARTNERSHIPS

SECTION 201. AMENDMENT OF SUBCHAPTER K OF CHAPTER 1 OF THE INTERNAL REVENUE CODE OF 1954

Section 201 of the bill, which corresponds to section 201 of the bill as passed by the House, makes numerous substantive and clarifying changes in subchapter K of present law and, in addition, rearranges the subchapter into the following parts, subparts, and sections:

SUBCHAPTER K—PARTNERS AND PARTNERSHIPS

PART I—RULES GENERALLY APPLICABLE TO PARTNERS AND PARTNERSHIPS

Subpart A—Determination of Tax Liability

Subpart B—Contributions to a Partnership

Subpart C—Distributions by a Partnership

Subpart D—Transfers of Interests in a Partnership

Subpart E—Treatment of Certain Liabilities

PART II—COLLAPSIBLE PARTNERSHIP TRANSACTIONS

PART III—SPECIAL RULES FOR PARTNERS AND PARTNERSHIPS

Subpart A—Special Rules in Determining Tax Liability

Subpart B—Interest in Partnership Capital Exchanged for Services

Subpart C—Termination of Retiring or Deceased Partner's Interest

Subpart D—Special Adjustments to Basis of Partnership Property

PART IV—DEFINITIONS

For cross reference tables showing the source of each section and showing the corresponding section of the 1954 code, see tables I and II in the appendix of this report.

Section 701. Partners, not partnership, subject to tax

Section 701 is identical to section 701 as contained in the House bill and is identical to section 701 of present law.

Section 702. Income and credits of partner

Section 702 is identical to section 702 of subchapter K as passed by the House, except for a change made by your committee in subsection (e)(3).

Subsection (a) is identical to section 702(a) of present law.

Subsection (b) corresponds to section 702(b) of present law but differs in several respects. First, the subsection specifically requires conduit treatment with respect to all partnership items, thus incorporating into the statute the treatment provided by existing regulations under the "catch-all" provision of section 702(a)(8). In other words, each partner must take into account separately his distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if the partner did not take the item into account separately.

Secondly, subsection (b) requires the conduit rule to be applied to items described in new subsection (e)(1)(A), which provides an election for simplified reporting.

Finally, subsection (b) makes it clear that the character of any item realized or incurred by the partnership, and included in a partner's distributive share, is determined as though he had realized or incurred such item directly. The subsection provides that, in making any such determination, due regard shall be given to any business, financial operation, or venture in which the partnership is engaged.

The application of section 702(b) may be illustrated by the following examples:

Example (1).—Partnership ABC, which is not engaged in the business of buying and selling real property, realizes a gain upon the sale of real property held for investment. Partners A and B are not separately engaged in the business of buying and selling real property, but partner C is engaged in that business in his individual capacity. The distributive shares of A and B of the gain realized by the partnership upon such sale will be capital gain in their hands, since neither the partnership nor partner A or B in his separate capacity is engaged in the trade or business of buying or selling real property. (Despite the fact that neither the partnership nor A (or B) is engaged in the business of buying and selling real property when looked at separately, if the activities of A when combined with the activities of the partnership, amount to the carrying on of a trade or business, A's distributive share would constitute ordinary income.) Since partner C is a dealer in real property and since under section 702(b) he is treated as having directly sold the real property sold by the partnership, his distributive share of the gain realized by the partnership on such sale is ordinary income, except that, if the real property sold by the partnership would have constituted investment property in C's hands if it had been held by him in his separate capacity, C's distributive share of the gain would be capital gain.

Example (2).—Partnership DEF is engaged in the business of buying and selling real property, and none of the partners are engaged in such business in their separate capacities. Since under section 702(b) due regard must be given to the business in which the partnership is engaged, each of the partners is considered to be engaged in the business of buying and selling real property. Therefore, each partner's distributive share of the partnership gain upon a sale of real property is ordinary income.

Example (3).—Individual G owns an interest in several partnerships. None of the partnerships is engaged in the business of selling real property but each of them sells some real property. Without regard to the activities of the partnerships, G is not a dealer in real property. However, if due regard is given to the cumulative effect of the sales of real property by the partnerships of which G is a member, the result may be to characterize G's distributive share of the gains realized by the partnerships from the sale of real property as ordinary income.

Subsection (c) clarifies present law by specifically preventing the double inclusion of a guaranteed payment, as defined in section 707, in a partner's gross income, once as a portion of his distributive share of partnership gross income and again as a guaranteed payment.

Subsection (d) clarifies present law by providing that any limitations on the amount of the exclusion or deduction of any item affecting the computation of taxable income (or on the amount of a credit) which are stated in terms of a fixed amount, or a percentage of income, are to be computed at the partner level rather than at the partnership level. The restriction on the use of certain depreciation methods is not a "limitation" for this purpose, and the choice of depreciation methods will continue to be made by the partnership.

Subsection (e), which has no counterpart in present law, provides a partnership election for simplified reporting by the partners. Under regulations, a partnership in which all the members are individuals may elect a modified form of conduit treatment. If this election is made, each partner, in determining his income tax liability, will take into account separately his distributive share of only four special partnership items: (1) long-term capital gains and losses, (2) short-term capital gains and losses, (3) gains and losses on property used in a trade or business or property involuntarily converted, and (4) dividends.

In addition, each partner will take into account a net amount representing his distributive share of all remaining partnership items of income, gain, loss, or deduction properly includible or allowable with respect to such partner in computing his taxable income.

Where such an election is in effect, the distributive share of remaining items is not to include any deduction not allowed to the partnership under section 703(a)(2) and is not to include any deduction or exclusion which under any provision of the Internal Revenue Code is limited to a fixed amount or a percentage of income. Thus, in determining the amount to be taken into account under subsection (e)(1)(B), no deduction shall be allowed, for example, for partnership charitable contributions, soil and water conservation expenditures and exploration expenditures.

While a partner who is a member of a partnership making the election under subsection (e) may apply the credit under section 34, attributable to his distributive share of dividends received from the partnership, he is not entitled to take into account any credit attributable to his distributive share of any other partnership item. For example, such a partner will not be entitled to the foreign tax credit provided under section 901 with respect to his distributive share of the taxes described in that section. Similarly, this partner will not be eligible for the retirement income credit (except to the extent of his distributive share of partnership dividends) and the credit for partially tax-exempt interest with respect to his distributive share of income of the partnership which serves to create the credit.

Under section 702(e)(3), as contained in the House bill, the election for simplified reporting was required to be made not later than the time prescribed by law for filing the partnership return for the taxable year with respect to which the election is made (including extensions of time), and such election was not revocable without the consent of the Secretary or his delegate. Under section 702(e)(3), as contained in your committee's bill, the election may be made or revoked for any partnership taxable year at any time before the expiration of 3 years from the last date prescribed by law for filing the partnership return for such taxable year (not including any extensions of time).

Section 703. Partnership computations

Section 703 (a) and (b) corresponds to section 703 (a) and (c) as contained in the bill as passed by the House. Section 703(b) (providing for the deduction of organizational expenses of a partnership), as contained in the House bill, has been deleted in your committee's bill. In accordance with the deletion of section 703(b), paragraph (3) of section 703(a) as contained in the House bill is also deleted in this bill. As a result of these changes the language of section 703 as contained in this bill is identical to section 703 of present law.

Section 704. Partner's distributive share

Section 704 is identical to section 704 as contained in the House bill and is identical, in substance, to section 704 of present law, except for the omission of paragraphs (2) and (3) of section 704(c) (relating to effect of partnership agreement and contribution of undivided interests, respectively) and section 704(e) (relating to family partnerships). Pursuant to the rearrangement of subchapter K, paragraphs (2) and (3) of section 704(c) of present law are set forth in the bill as subsections (a) and (b) of section 761, and section 704(e) of present law is set forth in the bill as section 762.

Section 705. Determination of basis of partner's interest

Section 705 is identical to section 705 as contained in the House bill, except for the deletion of section 705(b)(2)(D)

Section 705 of present law provides two rules for determining the basis of a partner's interest, a detailed general rule and a simpler alternative rule. The general rule requires a partner to determine the adjusted basis of his interest by taking the basis of the property originally contributed to the partnership, or the basis of the interest at the time of purchase, and then adjusting this for contributions, distributions, and certain items of income, loss, and expenditure. Under the simpler alternative rule the adjusted basis of a partner's interest is determined, in accordance with regulations, by reference to the adjusted basis of partnership property to which the partner would be entitled if the partnership were terminated at the time it became necessary to compute the basis for his partnership interest.

Under subsection (a), the simpler alternative rule of present section 705(b) becomes the general rule. Present section 705(a) under the rearrangement provided by the bill becomes section 763.

Under subsection (b), a partner who uses the simpler rule to compute the basis of his interest may, in connection with the examination of his return, or subsequent thereto, be required to prove that such rule produces the correct amount of his basis. This requires an affirmative action on the part of the Secretary or his delegate with respect to each specific taxpayer and is not to be covered by a blanket requirement set forth in the regulations or as a ruling of general application. The partner can meet this burden by showing, to the satisfaction of the Secretary or his delegate, that there has been no contribution to the partnership, transfer of an interest in the partnership, or distribution by the partnership which would result in a substantial difference between the basis of his interest computed under the simpler rule and the basis of his interest computed under the detailed rule. Thus, the partner will have the burden of establishing that there would be no substantial difference in the basis for his interest whether the computation was made under section 705(a) or under section 763.

Under subsection (b), if the partnership so elects (in accordance with regulations) the adjusted basis of the interests of all of the partners of such partnership will be required to be determined under the detailed rule. In other words, as long as this election is in effect, no partner may use the simpler rule of section 705(a) in determining the basis of his partnership interest.

Under the last sentence of section 705(b), notwithstanding the limitations of that subsection, the rule of section 705(a) may be applied if the partner's adjusted basis for his interest determined under that rule is further adjusted (under regulations) so as to eliminate any substantial difference between the basis so determined and the basis determined under section 763.

Section 706. Taxable years of partner and partnership

Section 706 is identical to section 706 as contained in the House bill.

Subsection (a) is identical, in substance, to section 706(a) of present law.

Subsection (b) clarifies present law by specifically providing in paragraph (1)(A) that a partnership may adopt a calendar year if all of its principal partners do not have the same taxable year, and by providing in paragraph (2) that a partner may not change his taxable year except as provided in section 442.

Subsection (c) is identical, in substance, to section 706(c)(1) of present law. Under the rearrangement section 706(c)(2) of present law is set forth as section 764(b).

Section 707. Transactions between partner and partnership

Section 707, which is identical to section 707 as contained in the House bill, corresponds to section 707 (a) and (c) of present law with minor changes in language to reflect the fact that subsection (b) of present section 707 is set forth as section 765 pursuant to the rearrangement of subchapter K.

Section 708. Continuation of partnership

Section 708, which is identical to section 708 as contained in the House bill, is derived from section 708 (a) and (b)(1) of present law.

Section 708(a) provides that an existing partnership is considered as continuing if it is not terminated.

Under section 708(b)(1)(A) the partnership terminates if no business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Section 708(b)(1)(B), like present law, provides that the partnership will terminate if, within a 12-month period, there are sales and exchanges which aggregate 50 percent or more of the total interest in both partnership capital and profits. However, unlike present law, a sale or exchange of an interest to a person who has been a member of the partnership for a continuous period of at least 12 months at the time of the sale or exchange is not a sale or exchange for this purpose. This new rule is effective with respect to sales or exchanges occurring in partnership taxable years which begin on or after the date of enactment of the bill. For example, if a sale to a person who has been a member of the partnership for 12 months occurs after such date of enactment but in a partnership taxable year which began prior to such date, such sale would be considered a sale for purposes of section 708(b)(1)(B).

Section 708(b)(1)(B) makes it clear that all sales or exchanges (other than those not to be taken into account under the preceding paragraph) occurring within a continuous 12-month period are aggregated in applying the 50-percent rule.

Section 708(b)(2) of present law becomes section 766 pursuant to the rearrangement of subchapter K.

Section 721. Nonrecognition of gain or loss on contribution

Section 721 is identical to section 721 as contained in the House bill.

Section 721(a) is identical to section 721 of present law.

Subsection (b) is new and consists of a cross-reference to section 770, a special provision relating to an interest in partnership capital exchanged for services.

No inference is to be drawn from the fact that there is no express exception in section 721 with respect to the matter covered in section 770.

Section 722. Basis of contributing partner's interest

Section 722 is identical to section 722 as contained in the House bill and corresponds to section 722 of present law, except for the addition of the rule that the basis of an interest acquired in exchange for the performance of services for the partnership is the amount deemed to be a contribution to the partnership under section 770(a).

Section 723. Basis of property contributed to partnership

Section 723 is identical to section 723 as contained in the House bill and to section 723 of present law.

Section 731. Extent of recognition of gain or loss on distribution

Section 731 is identical to section 731 as contained in the House bill and is identical to section 731 of present law, except that the reference in section 731(a)(2)(B) to unrealized receivables and inventory is changed to a reference to "section 751 assets," and the references in section 731(c) are changed to reflect the renumbering of certain sections pursuant to the rearrangement of subchapter K.

Section 732. Basis of distributed property other than money

Section 732, which is identical to section 732 as contained in the House bill, is identical to section 732 of present law, except that section 732(c)(1) provides for allocation first to any "section 751 assets" rather than to any unrealized receivables and inventory items, and except for the omission of section 732(d) of present law, which is renumbered as section 784 in accordance with the rearrangement of subchapter K.

Section 733. Basis of distributee partner's interest

Section 733, which is identical to section 733 as contained in the House bill, is identical to section 733 of present law.

Section 734. Basis of undistributed partnership property

Section 734 is identical to section 734 as contained in the House bill and is derived from section 734(a) of present law. Subsections (b) and (c) of section 734 of present law, relating to method of making the optional adjustment and the allocation of basis, respectively, are redesignated subsections (a) and (b) of section 781 in accordance with the rearrangement of subchapter K.

Section 735. Character of gain or loss on disposition of distributed section 751 assets

Section 735, which is identical in substance to section 735 as contained in the House bill, is derived from section 735(a) of present law. Under present law if a partner sells or exchanges unrealized receivables or inventory items distributed to him by the partnership, any gain realized by such partner is ordinary income in the case of the inventory items if they are sold within 5 years of the distribution, and in the case of unrealized receivables irrespective of how long after the distribution the sale occurs. Present law speaks only in terms of the "distributee partner." Therefore, if such partner makes a gift of the unrealized receivables or inventory items received by him, his donee may sell such items without being subject to the ordinary income treatment which would apply if the distributee partner had made the sale. New section 735 provides that the gain or loss on the sale or exchange of section 751 assets (a new concept substituted for both unrealized receivables and inventory items and discussed under sec. 751(a), infra) distributed to a partner is to retain its ordinary income character through all subsequent transfers of the property where the basis of the distributee partner for the property is carried over in whole or in part to the transferee. In addition, under new section 735, gain on all section 751 assets (including inventory items) will always be treated as ordinary income whenever sold by the distributee partner (or a transferee with a carryover basis) even though these items have been held more than 5 years.

Under section 204(b)(1) of the bill, new section 735 applies only to distributions made by the partnership in a partnership taxable year which begins on or after the date of enactment of this bill. Thus, a sale by a distributee partner in a partnership taxable year beginning after the date of enactment, of inventory items distributed in a partnership taxable year beginning before the date of enactment, will not be governed by new section 735. Therefore, in such a case, if the sale occurred more than 5 years after the distribution, the gain on the sale would not be characterized as ordinary income under present section 735(a). However, if at the time of such sale the distributed items otherwise constituted inventory items in the hands of the distributee partner, the gain on their sale would represent ordinary income.

Section 736. Holding period for distributed property

Section 736 is identical to section 736 as contained in the House bill. It is derived from section 735(b) of present law and is substantially the same.

Section 741. Recognition and character of gain or loss on sale or exchange

Section 741(a) corresponds to section 741 as contained in the House bill and is identical in substance to section 741 of present law.

Your committee has added a new provision, subsection 741(b), under which certain transfers of partnership interests are treated as liquidations under section 776, and as contributions. Under present law, if the transaction is in the form of a sale of an interest, then section 741 (rather than section 736) would govern, even though the interest of the selling partner is transferred to the other member of a two-man partnership. Under section 741(b), as contained in your committee's bill, even if the transaction is in the form of a sale of the partnership interest, the amounts paid for the entire interest are not to be treated under section 741(a), but are to be treated as amounts received in a liquidation to which section 776 applies, if such amounts are paid or payable ratably (or substantially ratably) by the other members of the partnership. Such payment made by each of the remaining partners is to be conisdered as a contribution by him to the partnership. If the partnership is a two-man partnership, the transfer of the entire interest of one of the partners to the other is always to be treated as a liquidation to which section 776 applies. Similarly, if the transaction is cast in the form of a sale of an entire partnership interest to the partnership, as distinguished from the partners as such, the transaction, as under present law, will be treated as a liquidation to which section 776 applies.

Under section 741(b), as contained in your committee's bill, it is intended that the amounts paid by the remaining partners to the withdrawing partner shall be considered to have been paid ratably if the amount paid by each remaining partner bears the same proportion to the total amount paid by the remaining partners as the fair market value of each such partner's interest in partnership capital and profits bears to the fair market value of the total interests in partnership capital and profits.

Your committee's bill also provides that, even if the payments are not ratable, but are substantially ratable, the amounts will be treated as received in a section 776 liquidation and as contributions to the partnership. The Secretary or his delegate has been given authority to promulgate such regulations as are necessary to carry out this provision.

The provisions of section 741(b) as contained in the bill will, in effect, treat the transaction as if an amount equal to the amount paid the withdrawing partner had been contributed to the partnership by the other partners and then paid by the partnership to the withdrawing partner in liquidation of his interest. Such liquidating payments become subject to all the provisions of section 776. Thus, for example, if all amounts payable by the remaining partners for the withdrawing partner's entire interest in the partnership are payable within a 12-month period, such amounts shall be considered as a distribution by the partnership. This, of course, brings into play the rules of section 750, if the partnership is collapsible.

Section 742. Basis of transferee partner's interest

Section 742 is identical to section 742 as contained in the House bill and is identical to section 742 of present law.

Section 743. Basis of partnership property

Section 743 is identical to section 743 as contained in the bill as passed by the House and is identical in substance to section 743(a) of present law. Subsections (b) and (c) of section 743 of present law, relating to adjustment to basis of partnership property and allocation of basis, respectively, are set forth, with modifications, as subsections (a) and (b) of section 782 in accordance with the rearrangement of subchapter K.

Section 746. Treatment of certain liabilities

Section 746, which is identical to section 746 as contained in the House bill, is identical to section 752 of present law.

Section 749. Sales and exchanges of interests in partnerships resulting in ordinary income

Section 749 corresponds to section 749 as contained in the House bill and is derived from section 751(a) of present law. The effect of section 749 is to require a partner who sells or exchanges his interest in a partnership to fragmentize the transaction into two parts if the potential ordinary income inherent in the partnership assets underlying the partnership interest sold is sufficient to meet the substantial appreciation test of section 751(d). Thus, the statute provides that the amount of any money and property received by a partner in exchange for his partnership interest shall be considered an amount received from the sale or exchange of an ordinary income asset to the extent that such amount is attributable to "substantially appreciated section 751 assets." The latter term is new. It is a substitute for the "unrealized receivables" and "substantially appreciated inventory items" of present section 751 (c) and (d), and is analyzed under section 751, infra. Any gain attributable to such assets must be reduced (but not below zero) by the amount of any section 751(b) loss in the same transaction. If the section 751(b) loss exceeds the gain attributable to substantially appreciated section 751 assets, such excess is to be subtracted from the gain or added to the loss on the portion of the transaction to which section 741 applies. For the definition of "section 751(b) loss" see the analysis of section 751(b), infra. Under section 751(c)(1), the character of partnership property for this purpose must be determined at the time of the sale or exchange of the interest as if the property were sold directly by the partner selling his partnership interest, giving due regard to any business, financial operation, or venture in which the partnership is engaged and as if all such property had been sold to one person in one transaction. Thus, some of the partnership assets might constitute section 1231 assets to one partner and ordinary income assets to another.

Section 749 removes an ambiguity in present law by providing that the section shall apply without regard to whether there is an overall gain or loss on the sale or exchange of a partnership interest. For example, assume that a partner having a basis of $10,000 for his partnership interest sells it for that amount, with the result that there is no overall gain or loss on that transaction. However, the partner's interest in partnership assets at that time included an interest in unrealized receivables having a basis of zero and a fair market value of $3,000. Under section 749 the sale of the interest is divided into two parts, with the result that the partner is treated as realizing $3,000 of ordinary income with respect to the interest in unrealized receivables which he surrendered and a capital loss of $3,000 on the other part of the transaction, i.e., the disposition of his partnership interest having a basis of $10,000 for the remaining $7,000 of the proceeds of the sale which had not been allocated to the unrealized receivables.

The application of section 749 may be further illustrated by the following examples:

Example (1).—C is a member of partnership ABC, and has a one-third interest in partnership capital and in partnership profits. C sells his interest to D at a time when the balance sheet of the partnership is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$3,000	$6,300	A........ $5,500
Sec. 1231(b) property	9,000	9,000	B........ 5,500
Capital assets	3,000	1,200	C........ 5,500
Total	15,000	16,500	16,500

The basis of each partner for his interest in the partnership is assumed to be the same as his share of the partnership's basis in its assets. C sells his interest to D for $5,500, which is C's one-third share of the value of all partnership property. C's overall gain on the sale of his partnership interest is $500 ($5,500, the amount realized, less $5,000, C's basis for his interest). However, because the inventory of the partnership meets the tests of section 751(d) and qualifies as substantially appreciated section 751 assets, C must, under section 749, treat the portion of the selling price of his interest attributable to the inventory ($2,100, one-third of $6,300) as an amount realized from the sale of property other than a capital asset. Under section 1001, C's gain on the inventory is determined to be $1,100 ($2,100, the amount realized, less $1,000 (one-third of $3,000) the portion of C's basis attributable to the inventory). Under section 749, this $1,100 gain must be treated as ordinary income. The balance of the transaction is treated under sections 1001 and 741, and results in a capital loss of $600 ($3,400, the portion of the amount realized attributable to C's one-third share of the value of section 1231(b) property and capital assets, less $4,000, the portion of C's basis attributable to such assets). Thus, although C has an overall gain of $500 on the sale of his partnership interest, he must report $1,100 of ordinary income and a capital loss of $600. If, however, C's share of the appreciation in inventory had amounted to only $1,000 (or less) the inventory would not have been considered to be substantially appreciated within the meaning of section 751(d). Consequently, the collapsible partnership rules would not come into play, and C would report a capital gain of $400 on the sale of his partnership interest.

Example (2).—Assume the same facts as in example (1), except that the selling price is $3,700 and that the partnership balance sheet is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$3,000	$6,300	A.......... $3,700
Sec. 1231(b) property	9,000	3,600	B.......... 3,700
Capital assets	3,000	1,200	C.......... 3,700
Total	15,000	11,100	11,100

As in example (1), C's gain attributable to the inventory is $1,100. However, there is a loss of $1,800 attributable to C's share of section 1231(b) property ($1,200, the portion of the amount realized attributable to C's share of section 1231(b) property, less $3,000, the portion of C's basis attributable to such property).

Under section 749, this $1,800 reduces the $1,100 gain attributable to the inventory to zero. The balance of the $1,800 not so applied ($700) is combined with the $600 loss attributable to the capital assets ($400, the portion of the amount realized attributable to capital assets, less $1,000, the portion of C's basis attributable to those assets), and the total loss of $1,300 is recognized under section 741 as a capital loss.

Section 750. Distributions which result in ordinary income

Section 750 corresponds to section 750 as contained in the bill passed by the House.

Section 750(a) is derived from section 751(b) of present law. Present law provides for the application of ordinary income treatment in the case of non pro rata distributions by a partnership, where, in effect, there has been a sale or exchange of an interest in unrealized receivables or substantially appreciated inventory items, either by the distributee partner or by the partnership.

Except for the substitution of the concept of "section 751 assets" for the terms "unrealized receivables" and "substantially appreciated inventory items," the only change from present law in the House bill is the provision for reducing any gain recognized to the distributee partner, or to the partnership, attributable to substantially appreciated section 751 assets, by the amount of any section 751(b) loss in the same transaction. Your committee's bill further changes present law by modifying the concept of substantial appreciation. "Section 751 assets", "section 751(b) loss", and the modified concept of substantial appreciation are described in the analysis under section 751, infra. In no event is the ordinary income realized with respect to substantially appreciated section 751 assets to be reduced below zero because of a section 751(b) loss. The section 751(b) losses can have an effect under section 750 only when more than a pro rata share of substantially appreciated section 751 assets is distributed (the case of recognition of ordinary gain by the partnership), or surrendered by the distributee partner (the case of recognition of ordinary gain by the distributee partner), since only when there are such gains does the section apply. In addition, to reduce any of these gains the distribution must be disproportionate with respect to the property involving the section 751(b) loss and the loss must be attributable to the same party realizing the ordinary gain.

Any gain recognized under this section is to be treated as realized in a transaction which is separate and apart from the distribution of any remaining property (to which sec. 731 will be applicable). However, a section 751(b) loss may affect either the portion of the transaction to which section 750 applies or the portion to which section 731 applies, or both. First, such a loss offsets any gain to which section 750 applies. To the extent such a loss exceeds the gain, it is treated as having been sustained in a transaction to which section 731 applies.

Section 750(b) corresponds, with one exception, to section 751(b)(2) of present law. It sets forth the exceptions to section 750(a), adding to the exceptions of present law an exception to the effect that the rules of section 750(a) shall not apply to a distribution of a partner's distributive share of the partnership income for the current year (including drawings and advances). Of course, section 750(a) does not apply to a distribution which is, in fact, a gift or payment for services or for the use of capital. In addition, section 750(b)(2), which exempts from the operation of section 750(a) those payments described in section 776(a) made to a retiring partner or successor in interest of a deceased partner, does not preclude the recognition of income under section 61(a) by a partnership which uses appreciated property to discharge an obligation to make a section 776(a) payment (which is not a partnership distribution) of a fixed amount to a retiring partner or deceased partner's successor in interest.

The application of section 750 may be illustrated by the following examples:

Example (1).—C has a one-third interest in the capital and profits of the ABC partnership. The partnership balance sheet is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$3,000	$6,000	A $4,800
Sec. 1231(b) property	9,000	7,200	B 4,800
Capital assets	3,000	1,200	C 4,800
Total	15,000	14,400	14,400

The basis of C's interest in the partnership is assumed to be the same as his share of the partnership basis of assets, i.e., $5,000. C receives section 1231(b) property having a fair market value of $4,800 as a distribution in complete liquidation of his interest in the partnership. The inventory items of the partnership come within the definition of section 751 assets as set forth in section 751(a). They are also substantially appreciated under the tests contained in section 751(d); i.e., their fair market value ($6,000) exceeds 125 percent of their basis ($3,000) and also exceeds 15 percent of the fair market value of all partnership property ($14,400). Also, it is assumed for purposes of this and the following example that the $1,000 de minimis amount of section 751(d)(2) has been exceeded as a consequence of other distributions during a 12-month period. Since C has received in a distribution partnership property other than substantially appreciated section 751 assets in exchange in part for his interest in substantially appreciated section 751 assets he is treated, under section 750, as having entered into a sale with the partnership. The analysis and consequences of this constructive sales transaction, both with respect to C and with respect to the partnership as constituted after the distribution, are as follows:

Analysis for C.—First, C is treated as receiving a pro rata distribution of all partnership property as follows:

Assets	Basis	Fair market value
Inventory	$1,000	$2,000
Sec. 1231(b) property	3,000	2,400
Capital assets	1,000	400
Total	5,000	4,800

At this point, C's basis in his interest in the partnership is treated as zero and his basis in the property deemed to have been distributed to him is deemed to total $5,000. Secondly, C is treated as selling the inventory and capital assets deemed to have been distributed to him for the additional amount of section 1231(b) property having a fair market value of $2,400 (non pro rata portion) received by him in the actual distribution from the partnership. Consequently, C recognizes $1,000 ordinary income (inventory with a basis of $1,000 and fair market value of $2,000 sold for sec. 1231(b) property having a fair market value of $2,000) and a capital loss of $600 (capital assets with basis of $1,000 and a fair market value of $400 sold for sec. 1231(b) property having a fair market value of $400). C's basis in the section 1231(b) property received in the distribution is $5,400 ($3,000 attributable to his pro rata (one-third) share of the partnership's basis for sec. 1231(b) property plus $2,400 ($2,000 of inventory and $400 of capital assets, the "purchase price" paid by C for the non pro rata share of sec. 1231(b) property distributed to him)).

Analysis for the partnership.—After the assumed pro rata distribution to C, the partnership balance sheet is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$2,000	$4,000	A........ $4,800
Sec. 1231(b) property	6,000	4,800	B........ 4,800
Capital assets	2,000	800	
Total	10,000	9,600	9,600

The partnership is treated as purchasing C's interest in inventory of $2,000 and in capital assets of $400, for the non pro rata portion of the section 1231(b) property distributed to C, having a basis to the partnership of $3,000 and a fair market value of $2,400. Accordingly, the partnership is treated as having sustained a loss of $600 on the constructive sale of the non pro rata portion of section 1231(b) property distributed. The partnership balance sheet after the transaction is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$4,000	$6,000	A........ $4,800
Sec. 1231(b) property	3,000	2,400	B........ 4,800
Capital assets	2,400	1,200	
Total	9,400	9,600	9,600

Example (2).—Assume the same facts as in example (1) except that C receives inventory having a fair market value of $2,300 and section 1231(b) property having a fair market value of $2,500 in liquidation of his interest in the partnership. Since C has received in a distribution substantially appreciated section 751 assets in exchange in part for his interest in other partnership assets he is treated, under section 750, as having entered into a sale with the partnership. The analysis and consequences of this constructive sales transaction both with respect to C and with respect to the partnership as constituted after the distribution are as follows:

Analysis for C.—First, C is treated as receiving a pro rata distribution of all partnership property as follows:

Assets	Basis	Fair market value
Inventory	$1,000	$2,000
Sec. 1231(b) property	3,000	2,400
Capital assets	1,000	400
Total	5,000	4,800

At this point, C's basis in his interest in the partnership is treated as zero and his basis in the property deemed to have been distributed to him is deemed to total $5,000. Secondly, C is treated as selling the capital assets deemed to have been distributed to him for the additional (non pro rata) amount of inventory having a fair market value of $300 and section 1231(b) property having a fair market value of $100 received by him in the actual distribution from the partnership. Consequently, C recognizes a capital loss of $600 (capital assets with a basis of $1,000 and a fair market value of $400 sold for inventory worth $300 and sec. 1231(b) property worth $100). C's basis in the inventory received in the distribution is $1,300 ($1,000 attributable to his pro rata (one-third) share of the partnership's basis for inventory plus $300, the "purchase price" paid by C for the non pro rata portion of the inventory distributed to him). C's basis in the section 1231(b) property distributed to him is $3,100 ($3,000 attributable to his pro rata (one-third) share of the partnership's basis for sec. 1231(b) property plus $100, the "purchase price" paid by C for the non pro rata portion of the sec. 1231(b) property distributed to him).

Analysis for the partnership.—After the assumed pro rata distribution to C, the partnership balance sheet is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$2,000	$4,000	A........ $4,800
Sec. 1231(b) property	6,000	4,800	B........ 4,800
Capital assets	2,000	800	
Total	10,000	9,600	9,600

The partnership is treated as purchasing C's $400 interest in capital assets in exchange for the non pro rata portion of the inventory items ($300) and section 1231(b) property ($100) distributed to C. Since the $300 of inventory used in this purchase had a basis of $150 to the partnership, ordinary income of $150 is realized by the partnership with respect to this item. On the other hand, the $100 of section 1231(b) property had a basis of $125, resulting in a loss of $25. This is a "section 751(b) loss" and is applied in reduction of the $150 gain, with the result that $125 of ordinary income must be taken into account by partners A and B. The partnership balance sheet after the transaction is as follows:

Assets	Basis	Fair market value	Partners' shares of fair market value
Inventory	$1,850	$3,700	A........ $4,800
Sec. 1231(b) property	5,875	4,700	B........ 4,800
Capital assets	2,400	1,200	
Total	10,125	9,600	9,600

Section 751. Definitions of section 751 assets and substantially appreciated section 751 assets

Section 751 corresponds to section 751 as contained in the bill passed by the House, but several changes have been made by your committee in section 751(d), relating to substantially appreciated section 751 assets.

Section 751(a) is new. It replaces subsections (c) and (d)(2) of section 751 of present law which define unrealized receivables and inventory items.

Section 751(a) defines "section 751 assets" to mean, for purposes of subchapter K, all property of the partnership except (1) capital assets, (2) property the gain on the sale or exchange of which would be treated as gain from the sale of a capital asset held for more than 6 months, and (3) property described in section 1231(b). For purposes of this definition all property of the partnership is deemed (under sec. 751(c)(2)) to have been held for more than 6 months (or for 12 months or more in the case of livestock described in sec. 1231(b)(3)) whether or not so held.

The test prescribed by section 751(a) substitutes for the special definitions of unrealized receivables and substantially appreciated inventory items contained in present law the capital gains rules which are generally applicable to taxpayers. Thus, in general, if sale or exchange of the asset would result in capital gain (taking into account the deemed holding period of sec. 751(c)(2)) such asset is not a section 751 asset. Conversely, if disposition would result in ordinary income the asset is a section 751 asset. Section 751(c) describes how the general capital gains rules are to be applied for purposes of section 751(a). It provides that the character of the property of the partnership in which the partner relinquishes an interest is determined (1) at the time of the sale or exchange of the interest (or at the time of distribution), (2) as if all property treated as sold or exchanged were sold directly by the person (or persons) relinquishing an interest in the property (giving due regard to any business, financial operation, or venture in which the partnership is engaged), and (3) as if all such property had been sold to one person in one transaction. As a result of rule (2) referred to in the preceding sentence, the property involved in a transfer or distribution might be a capital asset with respect to one partner and an ordinary income asset with respect to another partner. This difference in characterization stems from the requirement that the property in question be treated as if it were sold directly by the partner or partners giving up an interest in the property (disregarding the fact that the property interest was actually relinquished through the medium of a sale of an interest in a partnership or by means of a partnership distribution). See the analysis under section 702, supra, for the effect of determining the character of an item primarily at the individual partner level.

Section 751(b) is new. It is designed to reduce the ordinary income content of a collapsible partnership transaction to the extent of any offsetting ordinary loss element (i.e., the "section 751(b) loss") present in the same transaction. Section 751(b) defines the term "section 751(b) loss," for purposes of both section 749 and section 750, to mean the amount of any net loss which would result from the separate application of section 1231 with respect to all partnership property treated as sold or exchanged under section 749 or section

750, if all such property were sold at its fair market value. In other words, in the case of a sale or exchange of a partnership interest to which section 749 applies, all section 1231(b) property of the partnership in existence at the time of such transfer is treated as if it were sold at its fair market value at that time and the partner's share of the net loss, if any, which results from such computation is the section 751(b) loss. The transferor partner applies his share of the section 751(b) loss in reduction of the gain attributable to section 751 assets realized by him under section 749. In applying section 751(b) in the case of a distribution to which section 750 applies, separate determinations must be made with respect to property relinquished by the distributee partner and with respect to property relinquished by the partnership (as constituted after the distribution). Thus, in determining the amount of any section 751(b) loss attributable to a distributee, for example, there would be taken into account only the particular section 1231(b) property in which he was surrendering more than a pro rata interest. A similar rule would apply in the case of such a loss attributable to the remaining partners as constituted after the distribution. In addition, "the separate application of section 1231" means that section 1231 is to be applied only as of the time of the particular transfer or distribution and without regard to any prior or subsequent section 1231 transactions (except insofar as prior basis adjustments are concerned).

Section 751(c)(1) is new and provides that for purposes of section 751(b), as well as section 751(a), the character of any partnership property in which a partner relinquishes an interest is determined (1) at the time of the sale or exchange of the partnership interest (or at the time of distribution), (2) as if all property treated as sold or exchanged were sold directly by the person (or persons) relinquishing an interest in the property (giving due regard to any business, financial operation, or venture in which the partnership is engaged), and (3) as if all such property had been sold to one person in one transaction.

Section 751(c)(2) is new and provides that for purposes of section 751(a) and section 751(b) all property of the partnership shall be deemed to have been held for more than 6 months (or for 12 months or more in the case of livestock described in sec. 1231(b)(3)) whether or not so held. This means that it will not be necessary to provide separate treatment for short-term capital gains and long-term capital gains.

Your committee has changed section 751(d) as passed by the House by increasing the percentage tests of section 751(d)(1) (A) and (B) to 125 and 15 percent, respectively, by adding a $1,000 de minimis rule, and by providing that certain property acquired within a 12-month period is to be disregarded in applying the tests of substantial appreciation.

Section 751(d) is derived from section 751(d)(1) of present law but differs therefrom in several respects. First, whereas under present section 751(d)(1) the substantial appreciation test applies only to inventory items of the partnership, new section 751(d) applies this test to all section 751 assets. In other words, the collapsible partnership rules of sections 749 and 750 do not come into play unless the aggregate section 751 assets of the partnership are substantially appreciated. Under present law if the partnership has unrealized receivables (regardless of how small the amount) the collapsible partnership rules become operative in the case of every transfer of a partnership interest and in the case of every non-pro-rata distribution. Under new section 751(d) the presence of unrealized receivables will bring the collapsible partnership rules into play only if such items, together with any other section 751 assets, satisfy the test of substantial appreciation.

The percentage tests for substantial appreciation have been increased by your committee's bill from 120 and 10 percent to 125 and 15 percent, respectively, so that section 751 assets will not be considered substantially appreciated unless their fair market value exceeds (1) 125 percent of their adjusted basis to the partnership and (2) 15 percent of the fair market value of all partnership property, other than money, reduced by the liabilities of the partnership.

Another respect in which section 751(d) differs from present law is the requirement that in applying the 15-percent test the fair market value of partnership property be reduced by the liabilities of the partnership.

Section 751(d)(2) as contained in your committee's bill provides a $1,000 de minimis rule not found in present law or in the House bill. Under this rule section 751 assets are not considered substantially appreciated unless the excess of the fair market value over the adjusted basis of all such assets considered as sold or exchanged in a transaction, together with the excess of the fair market value over the adjusted basis of section 751 assets considered as sold or exchanged by the same partner or partnership in all other similar transactions within the 12-month period immediately preceding or following the transaction, exceeds $1,000. Thus, for example, if a partner sold a portion of his partnership interest on January 1, 1961, and another portion on January 1, 1962, and part or all of the amount received in each of these transactions was attributable to section 751 assets (which would be considered substantially appreciated, apart from the $1,000 test), then the excess of the fair market value over the adjusted basis of the section 751 assets deemed sold in each of the transactions would be lumped together in determining whether the $1,000 figure had been exceeded. For this purpose there would be no reduction for any section 751(b) loss. If the aggregate amount involved in the two sales mentioned above exceeded the $1,000 figure, then the section 751 assets involved in both sales would be considered "substantially appreciated" section 751 assets.

As used in section 751(d)(2) of your committee's bill the phrase "all other similar transactions" means, in the case of a transfer of an interest by a partner, all other transfers of interests in the partnership by the same partner, and, in the case of distributions, all other distributions with respect to the particular distributee partner or with respect to the partnership (as constituted after the distribution), as the case may be. In other words, transfers of partnership interests in which ordinary gains are realized are not to be aggregated with distributions which produce such gains. Also, transfers or distributions in which ordinary gains are realized by one person are not to be aggregated with transfers or distributions in which such gains are realized by another person.

Finally, section 751(d)(3), as added by your committee's bill, provides that, for purposes of the 125- and 15-percent appreciation tests, any assets contributed to, or otherwise acquired by, the partnership within a 12-month period immediately preceding the sale or exchange or distribution with respect to which the appreciation tests are being applied, shall be disregarded, unless there was a bona fide business purpose for the transaction in which the assets were contributed to, or otherwise acquired by, the partnership. This rule applies to all assets, whether section 751 assets or capital assets, and regardless of whether the assets were acquired by incurring indebtedness or the use of borrowed funds.

Section 761. Special rules for contributed property

Section 761 is identical to section 761 as contained in the House bill and, except for the addition of a cross-reference, is identical to paragraphs (2) and (3) of section 704(c) of present law.

Section 762. Family partnerships

Section 762 is identical to section 762 as contained in the House bill and is identical in substance to section 704(e) of present law.

Section 763. Alternative rule for determination of basis of partner's interest

Section 763, which is identical to section 763 as contained in the House bill, is derived from section 705(a) of present law. The circumstances under which the rule in section 763 is applicable are discussed in connection with the analysis of section 705, supra.

Section 764. Closing of partnership taxable year for deceased partner or partner who sells or exchanges part or all of interest

Section 764 corresponds to section 764 as contained in the House bill, with the exception of certain changes made by your committee in subsection (a).

Subsection (a) is new and provides that the taxable year of a partnership shall close with respect to a deceased partner as of the date of his death. However, under subsection (a) the successor in interest of the deceased partner (such as his executor or administrator) may file an election not to close the taxable year of the partnership with respect to such partner as of such date. Such election is to be filed in accordance with regulations.

If the election provided by subsection (a) is made, then, under your committee's bill, the taxable year of the partnership with respect to the deceased partner will close as of the time the first of the following occurs: (1) The close of the partnership taxable year, (2) the date of the sale or exchange or liquidiation (occurring after his death) of the entire interest of the deceased partner, or (3) the day following the death of such partner if the entire interest of such partner is sold or exchanged or liquidated at death by reason of an agreement which is operative on the death of such partner. These rules differ from the corresponding provisions of the House bill in that, in your committee's bill, the taxable year does not close, in the case of a deceased partner, upon sale, exchange, or liquidation of only a part of the interest of such partner. Under your committee's bill if part, but not all, of the interest of the deceased partner is disposed of at the time of his death, or after his death but before the close of the partnership taxable year, the distributive share of items described in section 702 (a) or (c) with respect to such interest is determined by taking into account the varying percentages of such interest during the partnership taxable year.

Subsection (b) corresponds to section 706(c)(2) of present law, except for the transfer to subsection (a) of the rules relating to the closing of the partnership taxable year for deceased partners and except for the addition of a reference to new subsection (e) of section 702.

Under section 204(b)(2) of the bill section 764 is made applicable with respect to a partner who dies on or after January 1, 1960.

Section 765. Certain sales or exchanges of property with respect to controlled partnerships

Section 765, as contained in your committee's bill, corresponds to section 765 as passed by the House, except that section 765(b) has been clarified so as to specifically cover sales and exchanges between a partnership and a corporation and a partnership and a trust or estate.

Section 765 (a), (b), and (c) is derived from section 707(b) of present law.

Subsection (a) disallows any deduction for losses arising from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between the following related parties:

(1) A person and a partnership in which more than 50 percent of the capital interest, or the profits interest, is owned by such person. The word "person" has been substituted for the word "partner" in existing law in order to encompass a transaction between a partnership and a person closely related to a partner, such as his wife. The words "directly or indirectly" in section 707(b)(1)(A) of present law are omitted from the new section 765(a)(1).

(2) Two partnerships in which the same person or persons own common interests of more than 50 percent of the capital interests or profits interests. The words "directly or indirectly" in section 707(b)(1)(B) of present law are omitted from the new section 765(a)(2), and a new concept denominated "common interests" and discussed below has been introduced.

(3) A partnership and a corporation in which the same person or persons own common interests of more than 50 percent of the capital interest, or profits interest, of the partnership and of the value of the outstanding stock of the corporation.

(4) A partnership and a trust or estate in which the same person or persons own common interests of more than 50 percent of the capital interest, or profits interest, of the partnership and of the value, actuarially computed, of the trust or estate.

Present section 707 does not deal with transactions between a partnership and a corporation, trust, or estate, and paragraphs (3) and (4) of subsection (a) have been added to specifically cover such cases.

Subsection (b) is based on section 707(b)(2) of present law but has been modified to exclude from its application land used in the trade or business. Consistent with the changes made in subsection (a), subsection (b) has been expanded by changing the word "partner" to the word "person," by introducing the "common interests" concept, and by deleting the phrase "directly or indirectly."

Subsection (b) as contained in your committee's bill makes it clear that ordinary gain, rather than capital gain, will result from sales or exchanges (1) between a partnership and a corporation in which the same person or persons own common interests of more than 80 percent of the capital interest, or profits interest, of the partnership and of the value of the outstanding stock of the corporation, and (2) between a partnership and a trust or estate in which the same person or persons own common interests of more than 80 percent of the capital interest, or profits interest, of the partnership and of the value, actuarially computed, of the trust or estate. Thus, subsection (b) of section 765, as contained in this bill, is coextensive with subsection (a) of that section, with the exception of the requisite percentages of ownership.

Subsection (c)(1) makes section 765 the exclusive provision for the disallowance of losses resulting from sales or exchanges between a person and a partnership, between two partnerships, or between a partnership and either a corporation, a trust, or an estate.

Subsection (c)(2) is identical, in substance, to section 707(b)(3) of present law.

Subsection (c)(3) is derived from the last sentence of section 707(b)(1) of present law.

Subsection (d), which has no counterpart in present law, sets forth a "common interests" rule the purpose of which is to establish when the relationship between the parties to a transaction is sufficiently close to bring the provisions of section 765 into operation. Your committee has made only correcting changes in the subsection in the House bill. This new concept applies to both the loss and gain provisions. Under subsection (d) the "common interests" of a person or persons in two organizations, between which there is a sale or exchange of property, is the smaller interest held by such person, or the sum of the smaller interests held by each of such persons, in such organizations. For purposes of this rule, an interest in an organization includes an interest in the capital or profits (whichever proportion is larger) of a partnership, the holding of outstanding stock in a corporation, and the beneficial interests, actuarially computed, in a trust or estate. The application of the new common interests rule may be illustrated by the following examples:

Example (1).—Partnership ABC sells property at a loss to partnership ABD. A has an 80-percent interest in the capital and profits of partnership ABC and a 10-percent interest in the capital and profits of partnership ABD. B has a 10-percent interest in the capital and profits of partnership ABC and an 80-percent interest in the capital and profits of partnership ABD. The common interest of A in the two partnerships is 10 percent, and the common interest of B is 10 percent. Therefore, the sum of the common interests held by A and B is 20 percent, and the loss will not be disallowed under section 765(a).

Example (2).—Partnership AB sells property (which in the hands of partnership AC is neither a capital asset nor land used in its trade or business) at a gain to partnership AC. A has a 90-percent capital interest and a 10-percent profits interest in partnership AB, and a 10-percent capital interest and 90-percent profits interest in partnership AC. Since the larger of A's capital and profits interests in each partnership is taken into consideration, A is deemed to have a 90-percent interest in each partnership. Applying the common interests concept the gain is treated as ordinary income to partnership AB.

Subsection (e) is new and provides a cross-reference to section 707 for general rules applicable in the case of transactions between partners and partnerships.

Under section 204(b)(3) of the bill section 765 applies only if the loss described in section 765(a) or the gain described in section 765(b) arose from a sale or exchange occurring on or after the date of enactment of the bill in a taxable year ending after such date.

Section 766. Continuing partnership in mergers or consolidations and divisions

Section 766 is identical to section 766 as contained in the House bill and is identical in substance to section 708(b)(2) (A) and (B) of present law.

Section 770. Interest in partnership capital exchanged for services

Section 770 corresponds to section 770 as contained in the House bill, except for a change made by your committee in the language of subsection (a)(2) and the addition of a new subsection (c)(2).

Section 770 provides specific rules which govern the treatment of an exchange of an interest in partnership capital for services rendered to the partnership. It is important to note that the section does not deal with the transfer of a partnership interest which gives the service partner merely the right to share in appreciation in partnership assets which occurs, or in partnership profits which are earned, subsequent to the date of transfer. Thus, for example, assume that a person who has been associated with a cash basis partnership as an employee is admitted as a partner in the partnership, and acquires an interest in the appreciation then existing in partnership assets, as well as an interest in profits of the partnership which have been earned as of that time, but not yet taken into partnership income. Such preexisting appreciation and previously earned profits are considered to be an interest in partnership capital, and section 770 is applicable. However, if such service partner had acquired only an interest in the appreciation occurring subsequent to his admission and in profits of the partnership earned after such time, the rules of section 770 would have no application.

Under subsection (a) the person receiving an interest in capital of the partnership in exchange for the performance of services for the partnership must include in gross income the amount determined under subsection (c). In addition, such amount is deemed to be a contribution to the partnership by the person performing the services. Since such an amount is treated as a contribution it also may increase the basis of partnership properties. However, this increase in basis of partnership properties will be limited to the amount of the excess of the fair market value of the interest transferred to the service partner over its adjusted basis to the partnership, since the remaining fair market value is already reflected in the basis of partnership property. There also are situations in which this basis adjustment for partnership properties is not to be made. Thus, under subsection (c) (discussed infra) there is to be no partnership basis adjustment for (or to) section 751 assets since appreciation attributable to these assets is not initially taxed to the service partner. Also, under subsection (b) (discussed infra) provision is already made for adjustment to the basis of partnership properties where the amounts attributable to the new partner's services are properly chargeable to capital account. Thus, in such cases a second upward adjustment to the basis of partnership properties would not be made as a result of the operation of subsection (a).

Under subsection (b) the partners relinquishing an interest in the capital of the partnership in exchange for the performance of services for the partnership do not recognize any gain or loss, even though the interest relinquished may have a fair market value different from its basis to the relinquishing partner. Furthermore, upon the relinquishment of a capital interest by a partner in exchange for the performance of such services, the partnership is allowed a deduction to the extent that the amount determined under subsection (c) constitutes a trade or business expense to the partnership, and the adjusted basis of the partnership property is increased to the extent that the amount determined under subsection (c) constitutes an amount properly chargeable to capital account. Subsection (b) also provides that the deduction allowed to the partnership is to be allocated among the relinquishing partners (or their successors in interest) on the basis of the portion of the deduction which is attributable to each such partner.

Subsection (c) sets forth the rules for determining the amount to be taken into account as income by the partner rendering the services and as a deduction or capital item by the partnership. If the interest at the time of the exchange is not subject to substantial restrictions or limitations as to its transferability by the service partner, such amount is the fair market value of the interest at the time of the exchange. However, if the interest transferred is subject to such restrictions or limitations, the amount to be taken into account is the lesser of the fair market value of the services rendered or the fair market value the interest would have had at the time of the exchange if there had not been such restrictions or limitations. The substantial restrictions or limitations as to transferability referred to in subsection (c)(1)(A) and (B) are restrictions or limitations which substantially affect the value of the partnership interest.

Subsection (c)(1) also sets forth the rules for determining the time when the amounts determined under that subsection are to be taken into account. If the interest acquired by the service partner is not, at the time of its acquisition, subject to substantial restrictions or limitations as to its transferability the amount determined under subsection (c) must be taken into account at that time. If the interest is subject to such restrictions or limitations at the time of its acquisition, the amount determined under subsection (c) must be taken into account at the time when those restrictions cease to be substantial (unless the interest is previously disposed of). If the interest acquired by the service partner is disposed of prior to the removal of the substantial restrictions and limitations upon its transferability, the amount determined under subsection (c) is taken into account at the time of such disposition. Under subsection (c)(1)(B) a transfer of a partnership interest by reason of death alone does not constitute a disposition for purposes of this subsection unless such restrictions or limitations terminate upon death. If substantial restrictions and limitations upon transferability terminate upon death, the amount determined under subsection (c) must be included in the decedent's return for his last taxable year and must be taken into account by the partnership as of the date of death.

Subsection (c)(2) of your committee's bill adds a provision not found in the House bill. Subsection (c)(2) provides that the amount required to be taken into account under section 770(c)(1) for purposes of section 770 (a) and (b) shall be reduced to the extent the fair market value of the interest exchanged is attributable to an excess in the fair market value of section 751 assets over their adjusted basis to the partnership. This provision assures that the service partner will not be taxed twice upon the appreciation which has taken place in ordinary income assets of the partnership prior to the acquisition of his interest.

Subsection (c)(3) (subsec. (c)(2) in the House bill) provides that the amount of the deduction allowed to the partnership under subsection (b)(1) is not to exceed the aggregate amount determined by taking into account, with respect to each relinquishing partner, his adjusted basis (as of the time of the exchange) in the relinquished interest, or that portion of the amount determined under subsection (c)(1), which is attributable to his relinquishment, whichever is the lesser.

For example, if, in exchange for services rendered to the partnership (which constitute a trade or business expense) partner A relinquishes an interest in partnership capital having a basis to him of $100 and a fair market value of $150, and partner B relinquishes such an interest having a fair market value of $150 and a basis to him of $200, the deduction allowed to the partnership shall be $250 ($100 attributable to A plus $150 attributable to B). Pursuant to the provision in subsection (b) that such deduction be allocated among the relinquishing partners on the basis of that portion of such deduction which is attributable to each such partner, this deduction is allocated $100 to A and $150 to B.

Under section 204(b)(4) of both the House bill and your committee's bill section 770 applies only in respect of exchanges described in section 770 occurring during any partnership taxable year beginning on or after the date of enactment of the bill.

Section 776. Amounts paid to a retiring partner or a deceased partner's successor in interest

Section 776 is identical to section 776 as contained in the House bill and is derived from section 736 of present law.

Subsection (a)(1) provides that amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall (except to the extent that they are attributable to an interest in partnership property as determined under subsection (b)) be considered as a distributive share of partnership income if such amounts are determined with regard to the income of the partnership and are paid or payable on or before the 15th day of the 4th month following the close of the partnership taxable year with respect to which such amounts are determined. Under subsection (a)(1)(B) such amounts are considered to be guaranteed payments if they are determined without regard to the income of the partnership or if they are paid or payable after the 15th day of the 4th month following the close of the partnership taxable year with respect to which such amounts are determined.

Paragraph (2) of subsection (a) adds rules which specify the time when the amounts referred to in subsection (a)(1) are to be taken into account. Under subparagraph (A) of this paragraph, any amount which is considered to be a distributive share under paragraph (1)(A) is to be taken into account by the partnership, and by the recipient, as of the last day of the partnership taxable year with respect to which such amount is determined. Under subparagraph (B) of this paragraph any amount considered to be a guaranteed payment under subsection (a)(1)(B) is to be taken into account by the partnership, and the recipient, as of the last day of the partnership taxable year in which such amount was paid or payable.

Subsection (b)(1) provides that amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall be considered as payable in a distribution by the partnership, and not as a distributive share or guaranteed payment under subsection (a), to the extent that such amounts are determined under regulations to be attributable to the interest of such partner in partnership property.

Subsection (b)(2) provides that amounts attributable to an interest in partnership property shall not include amounts attributable to unrealized receivables (as defined in subsection (c)(4)) and shall not include amounts attributable to goodwill except to the extent that the partnership agreement provides for a payment with respect to goodwill. Of course, reference to the partnership agreement is to the agreement as it existed at the time of death or retirement.

Subsection (c)(1) provides that if all amounts payable in liquidation of an interest in a partnership are payable within a 12-month period, such amounts are to be considered as a distribution and subsections (a) and (b) shall not apply. Thus, in such cases payments attributable to the retiring or deceased partner's interest in unrealized receivables or to goodwill (regardless of whether the partnership agreement provides for a payment with respect to goodwill) and payments in the nature of mutual insurance, as well as payments attributable to such partner's interest in other partnership property, will be subject to the distribution rules of section 731 (which, of course, includes the application of section 750 where appropriate).

Subsection (c)(2) provides that if amounts paid in liquidation of a partner's interest consist both of amounts considered as a distributive share or guaranteed payment and amounts considered as distributions, and such amounts are paid both in money and in other property, the money shall first be deemed to be in payment of the distributive share or guaranteed payment and only the excess of such money over such distributive share or guaranteed payment is deemed to be a distribution.

Subsection (c)(3) provides rules with respect to amounts, to which subsection (a) was applicable, which are paid after termination of the partnership in liquidation of the interest of a retiring or deceased partner. Subsection (c)(3)(A) provides that the recipient of such payments shall include them in his gross income as ordinary income, while subsection (c)(3)(B) provides that, if the person making such payments is an individual, was a partner of the partnership immediately before the retirement or death, is under a binding legal obligation to make such payments, and is operating a trade or business as a sole proprietor, then such individual is entitled to deduct such amount as a trade or business expense under section 162(a). The trade or business referred to in subsection (c)(3)(B) need have no relation to the trade or business carried on by the partnership, but it must consist of more than the performance of services as an employee.

Subsection (c)(4) defines unrealized receivables as rights to payments for services rendered and goods produced (or delivered in the case of a partnership predominantly engaged in a distributing trade or business such as retailing, wholesaling, and jobbing) to the extent that proceeds from the sale of such goods would be treated as amounts received from the sale or exchange of property other than a capital asset. The term does not include rights to payments previously includible in income under the method of accounting used by the partnership. Rights to payment for services not yet rendered or goods not yet delivered (or produced) do not come within the definition of unrealized receivables in subsection (c)(4). However, for purposes of section 776 such rights to payment constitute goodwill of the partnership. Accordingly, payments made to a retiring partner which are attributable to such rights to payment would come within section 776(b)(1) (if the partnership agreement provided for payment with respect to goodwill) or within section 776(b)(2) (if the partnership agreement contained no provision for payment with respect to goodwill). If the payment is a section 776(b)(1) payment, and if it results in a special basis adjustment under section 781, such adjustment will be allocable under section 783 to partnership goodwill and not to other partnership assets such as, for example, a bill rendered for services to be performed in the future.

Under section 204(b)(5) of both the House bill and your committee's bill section 776 applies only in respect of partners who die or retire during any partnership taxable year beginning on or after the date of enactment of this bill. Thus, even though payments are made to a retiring partner or a deceased partner's successor in interest after the date of enactment, section 776 will not apply to such payments if the partner retired or died in a partnership taxable year which began prior to the date of enactment.

Section 777. Cross-references relating to partnership income treated as income in respect of decedent and exception as to application of rule for property acquired from a decedent

This section, which is identical to section 777 as contained in the House bill, provides a number of cross-references relating to partnership income treated as income in respect of a decedent and relating to an exception as to the application of the rule of section 1014 for property acquired from a decedent.

Section 780. Manner of electing optional adjustments to basis of partnership property

Section 780, which is identical to section 780 as contained in the House bill, is derived from section 754 of present law. It provides for an election by the partnership with respect to distributions of property and transfers of partnership interests, pursuant to which the basis of partnership property is to be adjusted as provided in section 781 or 782, whichever is applicable. Unlike present law, section 780 permits the election with respect to transfers of partnership interests to be made separately from the election with respect to distributions. Also, unlike present law, section 780 provides that either such election may be filed, or changed, at any time prior to the expiration of 1 year after the time prescribed for filing the partnership return for the taxable year for which such election was filed, not including any extension of such time.

Under section 205(a) of both the House bill and your committee's bill if an election has been made under section 754 of present law, such election is to be treated as an election made both with respect to paragraph (1) and paragraph (2) of section 780. However, such election may be revoked either as to paragraph (1) or as to paragraph (2), but not as to both. The revocation of the election with respect to either paragraph may be made without the consent of the Secretary or his delegate, but, if made, must be made prior to the expiration of

1 year after the time prescribed by law (not including any extension of such time) for filing the partnership return for the first taxable year of the partnership beginning on or after the date of enactment of this bill. The revocation will have no effect with respect to any taxable year of the partnership prior to such first taxable year.

Section 781. Optional adjustment in case of distribution of property

Section 781, which is identical to section 781 as contained in the House bill, is derived from section 734 (b) and (c) of present law, but differs from that section in the manner of making the optional adjustment to the basis of partnership property. Under subsection (a)(1), if an election under section 780(1) is in effect, a partnership increases the adjusted basis of its property by the excess, if any, of the adjusted basis to the partnership of the property distributed over the reduction, as a result of the distribution, in the distributee partner's proportionate share of the adjusted basis of the partnership property. Under subsection (a)(2) the partnership decreases the adjusted basis of partnership property by the excess, if any, of the reduction, as a result of the distribution, in the distributee partner's proportionate share of the adjusted basis of the partnership property over the adjusted basis to the partnership of the property distributed. Thus, the adjustments under section 781 will reflect the difference between the basis to the partnership of the distributed property and the reduction which occurs in the distributee partner's proportionate share of the adjusted basis of the partnership property.

The application of subsection (a)(1) may be illustrated by the following example:

Assume that the assets of equal partnership ABD have a partnership basis of $9,000 and a fair market value of $15,000. D, who recently purchased his interest in the partnership from C for $5,000, has a $5,000 basis for his interest. A and B each has a basis for his partnership interest of $3,000.

Under present law if a $5,000 cash distribution is made by the partnership to either A or B in liquidation of his interest, the partnership would be entitled to an upward adjustment of $2,000 to the basis of remaining partnership assets. However, a similar distribution to D would result in no adjustment.

Under subsection (a)(1) there would be an upward adjustment of $2,000 regardless of which partner received the distribution.

Another respect in which section 781 differs from present law is the mandatory de minimis rule which it contains. Under this rule, if a distribution with respect to which the section 781 adjustment would otherwise be made would result in an aggregate upward or downward adjustment to partnership property of less than $1,000, no adjustment to the basis of partnership property shall be made. For example, if, as a result of a distribution at a time when the election under section 780(1) is in effect, upward adjustments of $2,000 are attributable to one class of assets and downward adjustments of $1,500 are attributable to another class of assets, the aggregate adjustment to the basis of partnership property under section 781 is only $500. However, because of the application of the $1,000 de minimis rule of section 781, no adjustment, either upward or downward, shall be made.

Section 782. Optional adjustment in case of transfer of interest

Section 782 is identical to section 782 as contained in the House bill.

Subsections (a) and (b) of section 782 are identical, in substance, to section 743 (b) and (c) of present law, except for the mandatory de minimis rule of subsection (a). Under this rule, if the transfer of a partnership interest, with respect to which the section 782 adjustment would otherwise be made, would result in an aggregate upward or downward adjustment to partnership property of less than $1,000, no adjustment to the basis of partnership property is to be made.

Section 783. Allocation of basis for optional adjustments

Section 783 is identical to section 783 as contained in the House bill.

Subsection (a) is identical, in substance, to section 755(a) of present law.

Subsection (b) is derived from section 755(b) of present law but differs in some respects. Present law requires a special basis adjustment attributable either to a distribution of partnership property or to a transfer of a partnership interest to be allocated to (1) capital assets and property described in section 1231(b), or (2) any other property of the partnership. The amended section 783(b)(1) omits the reference to a transfer of a partnership interest, and thus the rule contained in such provision will be inapplicable in the case of such a transfer. Second, subsection (b) provides that any special basis adjustment under section 781 shall be allocated to property of the same character (i.e., either capital assets and sec. 1231(b) property on one hand, or any other property of the partnership on the other hand) as that to which the adjustment is attributable. This differs from present law which requires that such allocation be made to property of the same character as that distributed. Third, subsection (b)(2) clarifies present law by specifically providing that the adjusted basis of any partnership property shall not be increased above its fair market value as a result of any special basis adjustment.

Section 784. Special basis to transferee upon subsequent distribution

Section 784 is identical to section 784 as contained in the House bill and corresponds to section 732(d) of present law. The operation of section 784 differs, however, from the operation of present 732(d) in that if the de minimis rule of section 782 would have precluded an adjustment under that section, no adjustment is to be made under section 784.

Section 785. Special basis to transferee upon subsequent sale or exchange

Section 785, which is identical to section 785 as contained in the House bill, provides for an election, not found in present law, under which a special basis adjustment is available to a transferee of a partnership interest.

Section 785 applies to a partner who acquired all or part of his interest by a transfer with respect to which the section 780(2) election was not in effect.

If such a partner sells or exchanges an interest in the partnership in a transaction to which section 749 is applicable, within 2 years after a prior transfer, then, for purposes of determining the partnership basis allocable to section 751 assets under section 749, he may elect to treat as the adjusted basis of the section 751 assets, attributable to the prior transfer, the adjusted basis which such section 751 assets would have if the section 782 adjustment were in effect with respect to the prior transfer. If the de minimis rule of section 782 would have precluded an adjustment under that section, no adjustment shall be made under section 785.

Section 788. Terms defined

Section 788 is identical to section 788 as contained in the House bill.

Under present section 761(a)(1), the Secretary of the Treasury or his delegate may exclude an unincorporated organization (which satisfies the requirements specified in the law) from the application of all or part of subchapter K, but only at the election of all the members of the organization. Under section 788(a)(2) the election is to be made by the organization. Of course, any organizations with respect to which a valid election was made under section 761(a) of present law will not be required to make an election under section 788(a)(2) as contained in this bill in order to be excluded from the application of all or part of subchapter K.

SECTION 202. INCOME IN RESPECT OF A DECEDENT

Section 202 of the bill, which is identical to section 202 of the House bill, amends section 691 of present law, relating to recipients of income in respect of decedents, by deleting subsection (e), which is a cross-reference to section 753 of present law, and by adding a new subsection (e) containing a specific listing of partnership items which are income in respect of a decedent. No inference to the effect that any of such items do not constitute income in respect of a decedent under present law shall be drawn from the enactment of section 202.

The specific items of income in respect of a decedent are contained in paragraphs (1) through (4) of new section 691(e). Paragraph (1) provides that where the partnership taxable year with respect to a deceased partner closes after the date of his death, the amount of his distributive share of items of income and gain described in section 702 (a) or (c) attributable to the portion of such taxable year ending on the date of his death is income in respect of a decedent.

Paragraph (2) is similar to present section 753. It provides that amounts includible under section 776(a) in the gross income of a successor in interest of a deceased partner constitute income in respect of a decedent. In general, such amounts are those payable in liquidation of the deceased partner's interest in the partnership, except amounts attributable to the interest of the partner in partnership property.

Paragraph (3) relates to amounts includible in the gross income of a successor in interest of a deceased partner which are attributable to the decedent's interest in partnership income of the type described in section 776(c)(4), which defines unrealized receivables. Paragraph (3) applies only in cases where such amounts are not already classified as income in respect of a decedent under paragraph (2). For example, if the executor of a deceased partner's estate sold, pursuant to a buy and sell agreement, the decedent's entire interest in the partnership, the proceeds attributable to the decedent's share of the unrealized receivables of the partnership at the date of his death would constitute income in respect of a decedent under paragraph (3), since paragraph (2) would not apply to such income. Similarly, if the partnership interest of the deceased partner is liquidated by payments from the partnership to his successor in interest made within a 12-month period, the portion of such payments attributable to the decedent's interest in the partnership's unrealized receivables at the date of his death is income in respect of a decedent by reason of paragraph (3).

Paragraph (4) applies to the case where a decedent acquired his interest in partnership capital in return for his services, but where the value of such interest was not includible in the income of the decedent before his death because of substantial restrictions or limitations upon his right to transfer such interest. Under paragraph (4), the amount required to be taken into account under section 770(a), determined as if section 770(c) applied, is taken into account as income in respect of a decedent by the successor in interest of the deceased partner at the time the restrictions or limitations cease to be substantial or such interest is transferred (within the meaning of section 691(a)(2)), whichever first occurs.

Deductions and credits with respect to partnership items shall be allowed under section 691(b) notwithstanding the fact that no specific listing of them is made in this bill.

Section 204(c) of the bill provides that the amendments made by section 202 shall apply only in respect of decedents dying during partnership taxable years beginning on or after the date of the enactment of the bill.

SECTION 203. TECHNICAL AMENDMENTS

Section 203 of the bill makes changes in a number of cross-references in other provisions of the Internal Revenue Code of 1954 in order to reflect changes made in subchapter K by section 201 of the bill.

Section 203(b) of the House bill, which made a technical change in the language of section 901(d)(2) to reflect the amendment which the House bill made in section 703, has been deleted in your committee's bill to correspond to the amendment made by your committee to section 703 as contained in the House bill.

Section 203(b) of your Committee's bill corresponds to section 203(c) of the House bill. Section 203(b) of your committee's bill clarifies present law by amending section 1014(c) to provide that section 1014(a) and (b) shall not apply to that portion of the value of an interest in a partnership attributable to property which constitutes a right to receive an item of income in respect of a decedent under section 691. Thus, a person who acquires a partnership interest from a decedent will not obtain a step up (or step down) of the basis of such interest to the extent that its fair market value is attributable to property of the partnership (such as unrealized receivables) which constitutes an item of income in respect of a decedent. However, your committee's bill provides that nothing in section 1014(c) shall prevent an increase in the basis of the interest of a deceased partner attributable to his distributive share of items of income and gain described in section 691(e)(1) to the extent such share was not withdrawn from the partnership prior to the death of the deceased partner. Since the share of partnership income for the portion of the partnership taxable year prior to the partner's death is income in respect of a decedent, it becomes taxable to his successor under section 691. The share of partnership income for the portion of the partnership taxable year following death becomes taxable to the successor under section 702 as his distributive share and results, under section 705, in a corresponding increase in the basis of such successor's interest in the partnership. The portion of the income taxed to the successor as income in respect of a decedent, of course, does not result under section 705 in an increase in interest basis. However, since that amount is taxed to the successor it properly should (to the extent not withdrawn before death) produce a corresponding increase in interest basis. Your committee's bill insures that such a step-up in basis will occur under section 1014.

Section 204(c) of the bill provides that the amendments made by section 203(b) shall apply only in respect of decedents dying during any partnership taxable year beginning on or after the date of enactment of the bill. However, no inference as to the treatment under present section 1014 of a partnership interest acquired from a decedent is to be drawn from the enactment of this subsection.

Subsection (c) amends section 1402(a), relating to the definition of net earnings from self-employment, in order to reflect the addition of subsection (e) to section 702.

SECTIONS 204 AND 205. EFFECTIVE DATES AND SPECIAL RULES

Sections 204 and 205 of your committee's bill are substantially identical to sections 204 and 205 of the House bill.

Subsection (a) of section 204 of the bill provides a general effective date. The amendments made by the bill are to apply with respect to any partnership taxable year beginning on or after date of enactment of this bill and with respect to any part of a partner's taxable year falling within such partnership taxable year.

Subsections (b) and (c) of section 204 provide a number of special effective date rules for certain new subchapter K provisions and for new provisions added to sections 691 and 1014(c). These rules are explained, supra, in connection with the various substantive provisions to which they relate.

Section 205(a) of the bill sets forth a transitional rule for making the separate elections under section 780 (as added by sec. 201 of the bill) in cases where the election has been made under present section 754. Section 205(b) provides for the continuation of certain provisions of present law during the transitional period. Under section 205(b), until the rules provided in the amendments made by this bill take effect, the provisions of the Internal Revenue Code of 1954 (as in effect before the enactment of this bill) shall continue to apply. Section 205(c) provides that, for purposes of the application of sections 7851 and 7852 of the Internal Revenue Code of 1954, any reference in those sections to the 1939 code shall be deemed to include a reference to the provisions of the 1954 code (as in effect before the enactment of this bill) unless manifestly incompatible with the intent of this bill.

V. APPENDIX

CROSS REFERENCE TABLES FOR PARTNERSHIP PROVISIONS

Table I

1954 Code section number	Section number as contained in section 201 of bill	1954 Code section number	Section number as contained in section 201 of bill
701	701.	731	731.
702(a)	702(a).	732(a)	732(a).
702(b)	702(b).	732(b)	732(b).
702(c)	702(c).	732(c)	732(c).
703(a)	703(a).	732(d)	784.
703(b)	703(b).	732(e)	732(d).
704(a)	704(a).	733	733.
704(b)	704(b).	734(a)	734.
704(c)(1)	704(c).	734(b)	781(a).
704(c)(2)	761(a).	734(c)	781(b).
704(c)(3)	761(b).	735(a)	735.
704(d)	704(d).	735(b)	736.
704(e)	762.	736(a)	776(a).
705(a)	763.	736(b)	776(b).
705(b)	705(a).	741	741(a).
706(a)	706(a).	742	742.
706(b)	706(b).	743(a)	743.
706(c)(1)	706(c).	743(b)	782(a).
706(c)(2)	764(b).	743(c)	782(b).
707(a)	707(a).	751(a)	749.
707(b)(1)	765(a), (c)(3).	751(b)	750.
707(b)(2)	765(b).	751(c)	751(a).
707(b)(3)	765(c)(2).	751(d)(1)	751(d).
707(c)	707(b).	751(d)(2)	751(a).
708(a)	708(a).	752	746.
708(b)(1)	708(b)(1).	753	777.
708(b)(2)(A)	766(a).	754	780.
708(b)(2)(B)	766(b).	755	783.
721	721(a).	761	788.
722	722.	771	(*).
723	723.		

*Section 771 carried the effective date provisions which are applicable to the transition from the 1939 Code to the 1954 Code. The comparable provisions, for the transition arising by reason of the amendments made by title II of the bill, are contained in section 204 of the bill.

TABLE II

Section number as contained in section 201 of bill	1954 Code section number	Section number as contained in section 201 of bill	1954 Code section number
701	701.	749	751(a).
702(a)	702(a).	750	751(b).
702(b)	702(b).	751(a)	751 (c), (d)(2).
702(c)	702(c).	751(b)	
702(d)		751(c)	
702(e)		751(d)	751(d)(1).
703(a)	703(a).	761(a)	704(c)(2).
703(b)	703(b).	761(b)	704(c)(3).
704(a)	704(a).	761(c)	
704(b)	704(b).	762	704(e).
704(c)	704(c)(1).	763	705(a).
704(d)	704(d).	764(a)	
705(a)	705(b).	764(b)	706(c)(2).
705(b)		764(c)	
706(a)	706(a).	765(a)	707(b)(1).
706(b)	706(b).	765(b)	707(b)(2).
706(c)	706(c)(1).	765(c)(1)	
707(a)	707(a).	765(c)(2)	707(b)(3).
707(b)	707(c).	765(c)(3)	707(b)(1).
708(a)	708(a).	765(d)	
708(b)(1)	708(b)(1).	765(e)	
708(b)(2)		766(a)	708(b)(2)(A).
721(a)	721.	766(b)	708(b)(2)(B).
721(b)		766(c)	
722	722.	770	
723	723.	776(a)	736(a).
731	731.	776(b)	736(b).
732(a)	732(a).	776(c)	
732(b)	732(b).	777	753.
732(c)	732(c).	780	754.
732(d)	732(e).	781(a)	734(b).
733	733.	781(b)	734(c).
734	734(a).	781(c)	
735	735(a).	782(a)	743(b).
736	735(b).	782(b)	743(c).
741(a)	741.	782(c)	
741(b)		783	755.
742	742.	784	732(d).
743	743(a).	785	
746	752.	788	761.

VI. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

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