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UPHOLSTERY REGULATORS

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MR. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 421]

The Committee on Finance, to which was referred the bill (H.R. 421) amending the Tariff Schedules of the United States to permit the importation of upholstery regulators, upholsterer's regulating needles, and upholsterer's pins free of duty, having considered the same, reports favorably with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

The House-passed bill amended the tariff schedules of the United States to make duty-free imports of upholstery regulators, upholsterer's regulating needles and upholsterer's pins.

The committee's bill is a substitute for the provisions of the House bill and includes the House-passed provision relating to the duty-free importation of upholstery regulators and upholsterer's regulated needles and pins as well as a series of tax amendments on which the committee believes immediate action is needed this year rather than having them held over until next year for consideration in connection with tax reform legislation.

The first tax provision in the committee's substitute bill extends for one additional year through December 31, 1975, four 5-year amortization provisions. The four provisions were enacted in the Tax Reform Act of 1969 for a 5-year period to make available the special rapid amortization as an incentive for certain types of investments. The types of investment covered by these four provisions are: (1) rehabilitation of low and moderate income housing, (2) pollution control facilities, (3) railroad rolling stock, and (4) certain coal mine safety equipment. The committee believes it is desirable to extend these four amortization provisions through next year in order to afford the committee time to reexamine the question as to how much longer each provision should be continued.

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The second tax provision deals with the tax treatment of accrued vacation pay. A permanent solution for the treatment of accrued vacation pay is provided to allow an employer to take a deduction in the case of accrued vacation pay which, except for contingencies (such as termination of employment before vacation time arrives), has already been earned by the employees. However, to prevent a doubling up of deductions in the case of an employer who is not covered by the provisions relating to accrued vacation pay in the Technical Amendments Act of 1958, if the employer elects to take deductions under this new provision for accrued vacation pay, he may not currently take a deduction for payments of the contingent amounts which accrued (on this basis) in years prior to the year in which the employer elects this treatment. This amount is held in suspense and is available as a deduction only to the extent that the end of the year liability for accrued vacation pay (on the new basis) is less than the beginning amount held in the suspense account.

The third tax provision relates to the application of the class life system to real property. Present law provides that after 1973, the class life system (sometimes referred to as the asset depreciation range or ADR provision) is to apply to real estate. The committee believes that bringing real estate into the ADR system before devising a satisfactory class life system for real estate would be unworkable. As a result, the committee bill does not apply the ADR system to real estate until such time as the Treasury Department develops regulations on a class life system for real estate.

The fourth tax provision contained in the committee's substitute bill deals with the tax treatment of real estate investment trusts. Under present law, a real estate investment trust (REIT) must meet certain income source tests (among other requirements) to be treated as a REIT and to be allowed "pass through" tax treatment whereby the income is taxed to the shareholders and not the trust. A series of revisions would be necessary for the tax treatment of real estate investment trusts to take into account the current practices and economic problems of the industry. However, the committee dealt with only the most pressing current problems of the industry, those relating to the treatment of foreclosure property. In view of the current economic situation, these have become immediate problems for the industry. The committee's bill generally provides that a REIT is not to be denied the "pass through" because of income that it receives from foreclosure property which formerly was classified as qualified real estate income, before it became necessary to foreclose on real estate mortgages. In general, instead the REIT will be taxed on the income from the foreclosure property and will have a period of time to sell the property or convert it into qualified property. The trust, however, will not be denied the pass through tax treatment with respect to its other income. The committee's bill also takes into account the difficulty a REIT faces as a result of the provision of present law prohibiting it from holding any property for sale to customers. In this regard, the bill modifies the rule to a limited extent to allow a REIT to hold foreclosure property for sale.

The fifth tax provision increases the interest rate paid by taxpayers on tax deficiencies, and by the government on tax overpayments, from 6 percent to 9 percent per year effective for obligations

outstanding on July 1, 1975. In addition to updating the tax interest at this time, the committee believes it is appropriate to provide a procedure whereby the interest rate in the future will be kept up to date with changes in the money market rates. As a result, the committee provided a procedure whereby the tax interest rate may be adjusted as the prime rate quoted by commercial banks to large businesses changes. The government interest rate is to be 90 percent of this prime rate but to be at the nearest whole interest rate and not to be changed more than once every two years.

The sixth tax provision is concerned with the tax treatment of student loan funding programs. Present law exempts interest paid on most State and local governmental obligations from Federal income tax. The committee included in the list of obligations, the interest from which is exempt from Federal income tax, qualified scholarship funding bonds where the student loan programs are financed by nonprofit higher education authorities which are requested by governmental units, even though they do not constitute a State or local government bond. In addition, the committee's bill makes it clear that student loan incentive payments made by the Commissioner of Education under the Emergency Insured Student Loan Act of 1969 are not to result in the treatment of the obligations as arbitrage bonds and in this manner disqualify the financing of these student loan programs for tax-exempt status.

The seventh tax provision deals with the exclusion from gross income of interest on U.S. bank deposits held by nonresident aliens. Under present law, interest received by nonresident aliens from deposits with persons carrying on the banking business, from deposits (or other accounts with savings and loan institutions or other similar associations, and from amounts held by an insurance company under an agreement to pay interest) is exempt from the 30-percent withholding tax on income or gain not effectively connected with the conduct of a trade or business within the United States. This provision, however, expires as of December 31, 1975. The committee has agreed to extend the termination of this provision for one additional year to December 31, 1976, to prevent (during 1975) an outflow of funds held as certificates of deposits with U.S. savings institutions. During this time the committee will review U.S. tax policies affecting all such types of investments.

The eighth committee tax provision provides that (1) where companies had issues of indebtedness outstanding on the date of the enactment of the interest equalization tax, (2) which were guaranteed by U.S. persons, (3) which were treated under that Act as debt obligations of a foreign obligor, (4) the obligation does not have a maturity date exceeding 15 years as of June 30, 1974, and (5) the obligation has been purchased by one or more underwriters with the purpose of distribution through resale, then the interest on the obligations is to be exempt from the 30-percent withholding tax in the case of interest payments to nonresident aliens. In addition, these obligations are to be exempt from U.S. estate tax when held by nonresident aliens. This provision is needed because the only other procedure available to companies since the interest equalization tax is no longer in effect if they are to continue to avoid the payment of the 30-percent withholding

tax is for the U.S. corporation to assume the obligations of its financing subsidiary. However, this would cause the financing subsidiary to realize income upon the discharge of indebtedness. The action taken with respect to the interest equalization tax was intended to exempt income from these obligations from tax and to make it possible to exclude them for estate tax purposes where they were held by foreigners. However, the repeal of this tax in practice inadvertently terminated these effects.

The final committee tax provision modified the tax treatment of political organizations in five major respects:

(1) It provided that political parties or committees (and separate campaign funds) are to be taxed on investment income and on income from a trade or business, but not on campaign contributions they receive. In addition, a $100 minimum is to be provided before any tax is payable on investment or business income. Generally, the political parties and committees are to be taxed as corporations but the surtax exemption is not to be allowed and the dividends received deduction is not to be available.

(2) The limited credit or deduction allowed under present law for campaign contributions to individual candidates (and parties and committees) is available only if a person has announced that he is a candidate for office in the year of the contribution. The committee's provision allows this credit or deduction in the year before a person announces his candidacy.

(3) Generally, newsletter committees (and separate funds) are to be treated for tax purposes in the same way as political campaign committees. That is, contributions received by the newsletter committees are not to be taxable to the individual or committee nor are the funds spent for a newsletter to be deductible. However, to the extent of any investment income or business income in the case of these funds, tax is to be imposed. Should funds be withdrawn from newsletter funds for personal purposes, however, tax is to be imposed at that time.

(4) Appreciated property transferred by a taxpayer to a political party or committee, if occurring after May 7, 1974, is to be taxed to the donor at the time of the transfer. A ruling already issued by the Internal Revenue Service taxes appreciation in property given before that date to the political party or committee receiving the property. However, this ruling is not to apply before August 2, 1973.

(5) Gift taxes are not to apply to contributions to political parties or committees.

Generally the provision outlined above has the effect of taxing the parties on any earnings, but not on the contributions they receive. At the same time, it prevents avoidance of tax by individuals by taxing them on any unrealized appreciation attributable to their contributions. It also makes clear that campaign contributions in reality are not a gift, but rather constitute contributions to further the general political or good-government objectives of the donor. Finally, the changes also deal with existing problems in connection with newsletter funds and technical difficulties arising in the case of the presently deductible or creditable political contributions.

II General Explanation

A. DUTY-FREE IMPORTATION OF UPHOLSTERY REGULATORS AND UPHOLSTERERS' REGULATING NEEDLES AND PINS

The first section of H.R. 421 under the committee substitute would provide duty free treatment for imports of upholstery regulators, upholsterer's regulating needles, and upholsterer's pins by establishing a new item 651.06 in the Tariff Schedules of the United States (TSUS) under which all imports of these articles would be free of duty.

Upholstery regulators are similar to knitting needles and are used to stuff furniture being upholstered. They are currently dutiable under TSUS item 651.04 at 9.5 percent ad valorem under rate column numbered 1 (applicable to imports from countries accorded most-favored-nation treatment) and 45 percent ad valorem under rate column numbered 2 (applicable to Communist countries, except Poland and Yugoslavia).

Upholsterer's regulating needles are eyeless needles, about 12 inches in length, and are currently dutiable under item 651.47 at 8.5 percent ad valorem under rate column numbered 1 and 40 percent ad valorem under rate column numbered 2.

Upholsterer's pins are 3 inches in length with a loop instead of a head. These pins are dutiable under item 657.20 at 9.5 percent ad valorem under rate column numbered 1 and 45 percent ad valorem under rate column numbered 2.

The committee is informed that there is no commercial production of these articles in the United States and that the domestic upholstery trade is dependent on imports of these articles, principally from West Germany and the United Kingdom. Imports of upholstery regulators and upholsterer's pins and regulating needles are not separately reported. However, it is known that the volume of such imports is small.

The bill, as reported by your committee, provides for treating the duty free status of the articles covered by the bill as having been proclaimed by the President under trade agreements rather than as statutory enactments. This would make possible, at some future time, the extension of escape-clause relief if appropriate.

No unfavorable comment on this provision was received by the committee. No objection to its enactment has been received from the executive departments or from any other source. Favorable reports on the bill have been received from the Departments of State, Treasury, and Commerce.

B. EXTENSION OF CERTAIN AMORTIZATION PROVISIONS FOR ONE YEAR

(Sec. 3 of the bill and secs. 167(k)(1), 169(d)(4)(B), 184(e) (1) and (7) and 187(d)(3) of the code)

In the Tax Reform Act of 1969, four provisions were enacted to make available a special 5-year amortization as an incentive to make certain investments. The types of investment made eligible for rapid amortization include (1) rehabilitation of low and moderate income

housing, (2) pollution control facilities, (3) railroad rolling stock, and (4) certain coal mine safety equipment.

In general, rapid amortization was made available as an alternative to the investment tax credit that was repealed in the 1969 Act. Each of the types of investment eligible for rapid amortization was considered important to the success of an existing social policy. Those programs relied entirely or partially upon private investment in order to accomplish their objectives, and Congress believed that an additional investment incentive restricted to these activities should be made available in lieu of the investment credit. When the investment credit was reenacted in 1971, Congress specifically provided that the investment credit and rapid amortization both would not be available for the same investment. A taxpayer may elect either the investment credit or rapid amortization.

All four of these special amortization provisions were enacted for a 5-year period which expires at the end of 1974.

After consultation with the appropriate Federal officials and public hearings during which interested private parties expressed their views, the committee concluded that there was still sufficient need for these provisions to warrant extending the expiration dates. Because of the late date in the year and the present state of the legislative calendar, the committee decided to extend each of the four provisions for one additional year, through December 31, 1975. Next year when it considers a tax reform bill, the committee plans to re-examine the question as to how long a time period each provision should be continued.

These four amortization provisions are summarized, as follows:

Rehabilitation of low and moderate income rental housing (sec. 167(k)).—Taxpayers may elect to compute depreciation on rehabilitation expenditures incurred after July 24, 1969, on low and moderate income rental housing under the straight line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. This rapid amortization is available only for low-income rental housing where the dwelling units are held for occupancy by families or individuals of low or moderate income, consistent with the policies of the Housing and Urban Development Act of 1968. The 60-month rule does not apply to hotels, motels, inns, or other establishments, where more than one-half of the units are used on a transient basis.

To qualify for the 60-month depreciation, the aggregate rehabilitation expenditures as to any housing may not exceed $15,000 per dwelling unit and the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Pollution control facilities (sec. 169).—Taxpayers may elect to amortize a certified pollution control facility over a period of 60 months. The amortization deduction is limited to pollution control facilities added to plants (or other properties) which were in operation before January 1, 1969. Thus, the special amortization provision was not made available in the case of facilities included in new plants built after 1968. Amortization is available for the first 15 years of the normal useful life of a pollution control unit. For example, where the useful life of a unit normally is longer than 15 years, say 25 years, the first 15 years (or 60 percent of the total cost of the facility) could be

treated as a separate property and amortized in 5 years. The remaining 10 years of useful life (40 percent of the total cost) could be treated as a second property with a 25-year normal useful life and depreciated under currently applicable regulations.

Eligible equipment has to be certified as a pollution control facility to the Secretary of the Treasury by the appropriate Federal and State authorities. Each facility, moreover, must be a separate, identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing or storing of pollutants, contaminants, waste or heat. Facilities that only diffuse pollution, rather than abate it, are not pollution control facilities.

Railroad rolling stock (sec. 184).—Specified classes of rolling stock are eligible for rapid amortization over 5 years, if the original use by the taxpayer is after December 31, 1968. The provision is available for the rolling stock of all domestic railroads, switching or terminal companies which are wholly owned by domestic railroads, and companies 95 percent or more of whose stock is owned by one or more railroads. Rapid amortization also is available to lessors for rolling stock leased to a domestic railroad or railroad company.

Coal mine safety equipment (sec. 187).—Taxpayers may elect to amortize over a 5-year period certified coal mine safety equipment. For this purpose certified coal mine safety equipment means electrical face equipment which is required in order to comply with the Federal Coal Mine Health and Safety Act of 1969 and which is certified as permissible under this Act by the Secretary of Interior and which is placed in service before January 1, 1975.

The equipment covered by this provision is designed to prevent sparking of coal mine equipment. When sparking occurs in coal mines with a sufficient concentration of methane gas, it can cause ignitions and explosions. This provision was enacted to ease the cost burden on operators of so-called nongassy mines who were required to install this safe electrical face equipment under the Federal Coal Mine Health and Safety Act of 1969.

Revenue effect.—There will be a decline of $5 million in tax liabilities in 1975 as a result of the one-year extension, and further declines of $4, $3, $2 and $1 million in succeeding years as the amortization is completed, if there are no additional extensions of the provisions.

C. ACCRUAL OF VACATION PAY

(Sec. 4 of the bill and secs. 81 and 463 of the code)

Under the 1939 Code, deductions for vacation pay could be taken when these expenses were paid or accrued, or paid or incurred, depending upon the method of accounting, "unless in order to clearly reflect income the deductions should be taken as of a different period." Under the above quoted portion of this provision, it was held by the Internal Revenue Service that vacation pay for the next year could be accrued as of the close of the year in which qualifying services were rendered, provided all of the events necessary to fix the liability of the taxpayer for the vacation pay under the employment contract have occurred by the close of the current year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred the fact that the employee's rights to a

vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ended before the scheduled period was not regarded as making the liability a contingent one instead of a fixed one. It was held that the liability in such a case was not contingent since the employer could expect the employees as a group to receive the vacation pay; only the specific amount of the liability with respect to individuals remained uncertain at the close of the year.[1]

In 1954, Congress enacted a provision (sec. 462) which provided for the deduction of additions to reserves for certain estimated expenses. Reserves for vacation pay, including accrual on a completion of qualifying service basis, would have been deductible under this provision and as a result it was concluded that it was no longer necessary to maintain the administrative position described above with respect to vacation pay. As a result, in Revenue Ruling 54-608 (C.B. 1954-2, 8), the Internal Revenue Service revised its position on the deductibility of vacation pay. In this ruling, it held that no accrual of vacation pay could occur until the fact of liability with respect to specific employees was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. It was thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rule set forth in this ruling would utilize this new provision (sec. 462) providing for the deduction of additions to reserves for estimated expenses. Thes ruling was initially made applicable to taxable years ending on or after June 30, 1955.

Because the provision relating to the reserve for estimated expenses was later repealed, the Treasury Department in a series of actions postponed the effective date of Revenue Ruling 54-608 until January 1, 1959.[2] These actions rendered Revenue Ruling 54-608 inapplicable to taxable years ending before January 1, 1959.

Congress, in the Technical Amendments Act of 1958 (sec. 97), further postponed the effective date of Revenue Ruling 54-608 for two more years, making it inapplicable to taxable years ending before January 1, 1961. Subsequently, Congress in six sections (P.L. 84-496, P.L. 88-153, P.L. 88-554, P.L. 89-692, P.L. 91-172 and P.L. 92-580) further postponed the effective date of Revenue Ruling 54-608. The sixth of these laws postponed the application of the ruling until January 1, 1973.

The application of Revenue Ruling 54-608 results in the denial of a deduction in a year where the accrual of vacation pay has not been clearly fixed with respect to specific employees. With the provisions for reserve for estimated expenses no longer a part of the law, this creates hardships for taxpayers who have been accruing vacation pay under plans which do not meet the requirements of the strict accrual rules set forth in this ruling. For such taxpayers, if this ruling were to go into effect, they would have one year in which they receive no deduction for vacation pay. This would occur since the current year's vacation pay deductions would have been accrued in

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[1] GCM 25261, C.B. 2, 44 ; I.T. 3956, C.B. 1949-1, 78.

[2] The last of these postponements was made in Revenue Ruling 57-325, C.B. 1957-2, 302, July 8, 1957.

the prior year and the next year's vacation pay does not meet the tests of accrual of this ruling.

Since the repeal of the provision relating to the reserve for estimated expenses in 1955, the House and Senate committees have indicated that this problem needed to be studied before permanent legislation would be prepared. A provision has been developed as a result of such study and insofar as accrued vacation pay is concerned the committee believes it represents the permanent legislation promised by the committees.

Election.—The committee's bill provides for an election by a taxpayer who computes his income by the accrual method of accounting to obtain a deduction as a trade or business expense (if the conditions for deductibility as a business expense are otherwise satisfied under sec. 162) for both the vested and contingent amounts of vacation pay (reflected as reasonable additions to a vacation pay accrual account maintained by the taxpayer) which were earned by the taxpayer's employees before the close of the taxable year and payable during that year or within 12 months thereafter.[3] For purposes of this provision amounts are to be treated as payable during a taxable year or within 12 months thereafter if the employees have a right to receive the payments during this period even though actually paid to them at some time subsequent to that period.

Opening balances in account.—To prevent a doubling-up of vacation pay deductions in the first year of the election provided in the bill, two rules are provided for computing the opening balance of the vacation pay accrual account. First, if the taxpayer maintained a predecessor account for vacation pay under the Technical Amendments Act of 1958 (sec. 97) (for his last taxable year ending before January 1, 1973 and makes the election for his first taxable year ending after December 31, 1972), the opening balance is the larger of the balance as of the close of the preceding year in the predecessor vacation pay accrual account maintained by the taxpayer or the amount determined as if the taxpayer had maintained such an account for the preceding year. Second, if the taxpayer did not maintain a predecessor account, then the opening balance is an amount equal to the largest closing balance the taxpayer would have had for any of the three years immediately preceding the first taxable year for which the election is in effect as if the taxpayer had maintained such an account throughout the 3 immediately preceding taxable years. The liabilty for vacation pay earned by the taxpayer's employees before the close of the year may include amounts which but for the provisions of this bill would not be deductible as an accrued trade or business expense because of contingencies. All payments for vacation pay must be charged to this account if the taxpayer elects to deduct vacation pay as provided under the bill.

Suspense account.—To prevent the permanent loss of vacation pay deductions contained in the opening balance of the vacation pay accrual account, the bill establishes a suspense account with an initial amount equal to the opening balance of the vacation pay accrual ac-

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[3] In some cases, the taxpayer may also obtain a deduction in the amount of the reduction (as of the close of the year) in the special vacation pay suspense account provided for by the bill.

count minus the amount of the accrual which has been allowed as deductions in prior years (but not paid by the beginning of the first taxable year for which the election applies). This suspense account initial amount, if any, is determined at the beginning of the first year for which the taxpayer elects to determine his vacaton pay deduction under this bill. At the close of each year, the suspense account is reduced by the amount, if any, by which the beginning balance of the suspense account exceeds the ending balance of the vacation pay accrual account (after making all additions and charges for the year). The application of the suspense account to any amount attributable to a transfer to which section 381(a) applies is to be determined by regulations prescribed by the Secretary of the Treasury or his delegate.

To insure that the balance in the suspense account is only used when there is a permanent reduction in the vacation pay plan (and not when there are temporary reductions), the committee's bill provides that the balance in the suspense account is to be increased (but not in an amount greater than the initial balance in the suspense account). The increase is the excess (if any) of the balance in the accrued vacation pay account at the close of the taxable year (after making the additions and charges for the year) over the amount in the suspense account at the beginning of the taxable year. The amount of this increase is to be included in gross income (sec. 81(2)).

Other rules.—The election by the taxpayer to compute his business deduction for vacation pay under this bill may be made at the time and in the manner prescribed by the Secretary of the Treasury or his delegate. If an accrual basis taxpayer elects to compute his business deductions for vacation pay under this bill, he is not to be considered as having changed his method of accounting, and no adjustment is required in the computation of his income because of the treatment of vacation pay provided here. If a taxpayer treated his predecessor vacation pay accrual account under section 97 of the Technical Amendments Act of 1958 for his last taxable year ending before January 1, 1973, but fails to make the election provided by the bill for his first taxable year ending after December 31, 1972, he is to be treated as having initiated a change in accounting method for purposes of section 481, with respect to vacation pay. Under the amendment made by the bill a taxpayer who had previously deducted contingent liabilities for vacation pay, but who fails to make the election, cannot continue to take this deduction.

The term "vacation pay" as used in the bill includes amounts paid or to be paid to an employee during the time he is on vacation or amounts paid or to be paid to an employee in lieu of a vacation (so long as the choice is solely the employee's). However, vacation pay does not include amounts for items such as sick pay or holiday pay.

If a taxpayer is deducting vested vacation pay liabilities with respect to a vested plan, he need not make the election provided in the bill in order to continue to deduct the vested liabilities.

Effective date.—The provisions of the bill apply to taxable years beginning after December 31, 1973, except if the taxpayer maintained a predecessor account under the Technical Amendments Act of 1958 in which case it applies to taxable years ending after December 31, 1972.

Revenue effect.—The revenue effect of this provision is negligible (a loss of revenues of less than $500,000).

D. APPLICATION OF CLASS LIFE SYSTEM TO REAL PROPERTY

(Sec. 5 of the bill)

The Revenue Act of 1971 provided a new unified system of class lives for depreciation purposes which may be elected by taxpayers for assets placed in service after 1970. (These new rules are commonly referred to as the asset depreciation range or the ADR provisions.) A taxpayer which elects to determine the useful life of assets it acquires during a taxable year under this class life system generally must use this system for all assets acquired during the year which fall within any class for which the Treasury Department has established a class life.

In the case of real estate, however, Congress in 1971 recognized that under the rules of the 1962 guidelines, taxpayers in many cases were permitted to depreciate real property over shorter lives than the guideline lives because of the particular facts relating to the property. If these taxpayers were, as a condition of electing the class life system, required to include the real property in the election, they would be substantially, adversely affected since they would have to use significantly longer lives for the real property than they had used in the past. In view of this, Congress in the 1971 Act provided a transitional rule for these taxpayers to enable them to elect the class life system for other assets while the Treasury Department studied the general matter of the appropriate lives for real property. As a result, in the case of real property placed in service during the 3-year period beginning on January 1, 1971, taxpayers who elect the class life system may exclude from the election real property in cases where for the first year a life shorter than the intially prescribed class life (which is to be the 1962 guideline life) is justified for the asset under the rules of the 1962 guidelines.

Since this transitional period has expired, the application of the class life system to real estate is to apply after 1973. The Treasury Department has informed the committee that it has not yet completed its study for providing a system for incorporating real estate into the ADR system and has requested that the provision in the 1971 Act which applies the ADR system to real estate after 1973 be repealed. The committee is concerned that the effect of bringing real estate into the ADR system before devising a satisfactory system would be to unfavorably disturb the remainder of the system. As a result, the committee believes it is appropriate at this time not to apply the ADR system to real estate.

As a result, the committee's bill repeals the provision requiring the application of the ADR system to real estate after 1973 (paragraph (1) of section 109(e) of the Revenue Act of 1971). In the case of real property placed in service before class lives have been prescribed for real property, a taxpayer who has elected the ADR system may also elect to determine the useful life of depreciable real property under Revenue Procedure 62–21 as in effect on December 31, 1970 (to the extent the provisions of that revenue procedure are applicable to

real estate), or on the basis of the facts and circumstances of the particular case.

Effective date.—The amendment made by this provision is to apply with respect to property placed in service after December 31, 1973.

Revenue effect.—It is not believed this provision will have any effect on revenues.

E. REAL ESTATE INVESTMENT TRUSTS—TREATMENT OF FORECLOSURE PROPERTY

(Sec. 6 of the bill and secs. 856 and 857 of the code)

Under present law a real estate investment trust (REIT) must meet certain income source tests (among other requirements) to be treated as a real estate investment trust and to be allowed "conduit" tax treatment. Thus, for example, 75 percent of the income of the trust must be from certain qualified real estate income sources to meet these tests (and 90 percent of its income must be from these sources and certain other passive sources of income). In addition, certain types of income from real estate (such as rents which are based on profits) are not treated as qualified income because a REIT is intended to be wholly passive investor and not an active business competitor with businesses which do not receive conduit tax treatment. However, no allowance is made in present law for a situation where a REIT, inadvertently, as the result of an unanticipated default of its debtor, takes over real property under exisitng mortgages or leases that yielded nonqualified income.[1] Therefore, under present law a REIT must meet the income source tests even if it receives nonqualified income from foreclosed real property, and even if the trust has had no opportunity to influence the type of income received from such property. As a consequence, a trust may become disqualified involuntarily or may have to take action which is not economically sensible to remain qualified.

In addition, often the best course for a REIT that acquires real property on foreclosure is to sell off the property. However, under present law, such action could cause the trust to be disqualified as holding propety for sale to customers in the ordinary course of its trade or business. Under these circumstances, (and particularly in view of the present economic situation facing the real estate industry), the committee believes that relief should be granted to real estate investment trust that involuntarily acquire property on foreclosure.

Foreclosure rules.—As a result of these problems, the committee has provided in its bill that, generally, a REIT is not to be disqualified because of income that it receives from foreclosure property since the REIT is not to be held responsible for the type of lease or other transaction entered into by its mortgagor. At the election of the REIT, a two-year grace period—generally subject to one-year extensions—is to be allowed so that a REIT may liquidate the foreclosed property in an orderly manner, or negotiate changes in, *e.g.*, leases on the property so the income received is qualified. However, during the grace period the

[1] Present law does recognize that a REIT may involuntarily receive income when its property is condemned. In this case the 30 percent gain-from-sale limitation does not include gain from involuntary conversions. (Sec. 856(c)(4)(B).)

REIT is to pay corporate tax on nonqualified income received from property acquired on foreclosure.

The foreclosure rules of the bill are to be wholly voluntary. No real property will be treated as foreclosure property subject to these rules unless the REIT elects to have the new rules apply (in a manner to be prescribed in regulations). A REIT is to make the election (which is irrevocable) to have these rules apply by the date for filing its tax return (including extensions) for the year in which the trust acquires the property in question. Generally an election is to be made on a property-by-property basis.

Since the rules relating to foreclosure property are to apply to such property acquired after December 31, 1973, the general time for electing to have the rules apply may not be sufficiently long for trusts which report on a fiscal year basis. Consequently, the bill also provides that an election may be made up to 90 days after the date of enactment of the foreclosure provisions, if this would be later than the general time limit for an election.

Foreclosure property.—Foreclosure property which will be subject to the new rules of the bill (on the election of a REIT) generally is to be real property which is acquired by a REIT after default, or on imminent default, of a mortgagor to the REIT. Real property will be acquired on foreclosure when a REIT which holds an obligation secured by the real property bids in the amount of the secured obligation, etc., at a sale of the property.[2] In the case of a sale-leaseback arrangement (which is closely analogous to a mortgage), real property also will be foreclosure property when a REIT, which is a lessor, acquires possession of the property from its defaulting lessee.[3] It is not necessary for a REIT to go through a formal judicial or administrative process for property acquired on default to be foreclosure property; other mechanisms available under State or local law for acquisition on default will be sufficient. Additionally, it is not necessary that a debtor or lessee actually have defaulted on his obligation to the REIT for property acquired to be foreclosure property. Since acquisition from a debtor may occur when default is imminent, it is unnecessary to go through the act of a formal default (but there must, of course, be significant evidence that default was imminent).

Since the foreclosure rules of the bill are to provide relief for situations where a REIT inadvertently acquires property on foreclosure, the committee intends that the rules are not to apply with respect to real property acquired under a mortgage or lease that was entered into by the REIT (or acquired by the REIT) with an intent to foreclose or evict. Also, where a REIT acquires a mortgage or property subject to a lease when it knew or had reason to know that default would occur, the foreclosure rules are not to apply.

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[2] Foreclosure could be under a mortgage, deed of trust or other instrument; a foreclosure sale could be a judicial sale, sale by a trustee, or other sale provided for by law; a REIT might bid in the amount of the obligation (plus interest and penalties), or might bid in cash, etc., as will satisfy local law. Of course when a REIT stands in the place of any third person unrelated to the property, if it acquires the property in a foreclosure sale (or imminent foreclosure) the new foreclosure rules will not be available.

[3] The committee expects, however, that in the case of a lease the Service will examine the matter carefully, to be sure that there was a reasonable expectation that there would not be a default under the lease, to prevent a situation where the REIT might attempt to use a straw man as lessee, use the straw to enter subleases paying unqualified rent, and then arrange a "default."

Foreclosure property includes personal property acquired on foreclosure if the personal property is incidental to (and, therefore, used with) the real property acquired on foreclosure. For example, where a REIT forecloses on a hotel and acquires all of the personal property of the hotel (e.g., furniture, appliances, etc.), this personal property will be treated as foreclosure property. However, foreclosure property does not include personal property acquired on foreclosure of a lien, where the personal property is not incidental to the real property.

Subsequent leases.—Under the bill, a REIT is not to enter into a lease after it acquires the foreclosure property, which would yield income that does not qualify for the 75 percent income test. The special foreclosure rules are designed to give a REIT time in which it can change the income received from nonqualified to qualified income, and it would be inconsistent with this objective to allow the REIT also to enter into leases which would yield nonqualified income.

The bill provides that if, after acquiring the property on foreclosure, a REIT enters into a lease with respect to the foreclosure property which, by its terms, will give rise to income which is not qualified real estate income under the 75 percent income source test, the property will immediately lose its status as foreclosure property. For example, a REIT is not to enter into a lease with respect to foreclosure property where any amount which will be received or accrued directly or indirectly by the REIT with respect to that property depends in whole or in part on the income or profits derived by any person from the property. Rents from this type of lease do not qualify for the income source test under present law (sec. 856(d)). Thus, on entering into such a lease, the property will immediately lose its status as foreclosure property.[4]

If a REIT enters into a lease which will yield a fixed rent, plus a contingent amount which is dependent on the profits in excess of a specified dollar figure, the lease by its terms will not definitely give rise to nonqualified income. However, if any amount is received or accrued by the REIT under the percentage of profits provision, at that time the property will lose its foreclosure property status.

Foreclosure status may also be terminated where the REIT enters indirectly into an arrangement that results in nonqualified income. For example, if the REIT enters into a lease where the rent is based on a percentage of the tenant's gross receipts or sales, and the tenant has a sublease based on a percentage of the sublessee's profits, then the rent received by the REIT would be nonqualified (as under present law) and the property would cease to qualify as foreclosure property.

Also, if a REIT delays foreclosure in order that the debtor might enter into a new lease with bad income, that is to be treated as if the REIT itself entered into the lease, and the property would not be entitled to the status of foreclosure property.

Where there is an extension or renewal of an existing lease and the REIT cannot control the terms of the lease, this will not be treated as a new lease, and the renewal will not terminate the status of the property as foreclosure property, even if nonqualified rent is payable under

[4] However, to improve the saleability of the property, the REIT could enter into a percentage-of-profit lease where the percentage of profit clause does not become effective until the REIT is no longer the owner of the property and where the REIT receives no rents from such a clause.

the lease. But, if the REIT had a right to renegotiate the terms of the lease, then it will be treated as having entered into a new lease.

Under the rule dealing with new leases, the real property in question is to be the entire property acquired by foreclosure. For example, if a REIT forecloses on a shopping center and the shopping center has individual leases with each store, the "property" for purposes of the lease rule is to be the shopping center. Consequently, if the REIT enters into a bad lease with any shopping center tenant, the shopping center as a whole is to lose its status of foreclosure property, since this lease would be evidence that the REIT is not following the foreclosure rules in good faith.

Construction on foreclosure property.—Under the foreclosure rules in the bill, a REIT will be able to complete construction of a project where there has been so much construction that it would be difficult to dispose of the property unless the project is completed. This is necessary for a REIT to make a project economically viable and for the REIT to preserve its investment. The bill provides, therefore, that a REIT may cause construction to take place on foreclosure property where more than 10 percent of the building (or other improvement) was completed before default became imminent. If the REIT causes construction in other circumstances, the property will lose its status as foreclosure property. (Any construction which a REIT causes is to take place through an independent contractor, as under present law.)

The 10 percent rule will not prevent a REIT from providing needed repair and maintenance to fix up a building for sale. But, repair and maintenance is not to be construed to include renovation of a building (such as remodeling apartments or changing an apartment building from rental units to a condominium, etc.); in this case the 10 percent rule must be met.

Under the 10-percent test, it is intended that the cost of construction is not to include architects' fees. While architects' work is vital to construction, this work generally will not make sale more difficult. To the contrary, if architectural work has been done with respect to property, this work probably will make it easier to sell the property. Therefore, the fact that architectural work has been done will not make it necessary to all ow a REIT to complete construction.

A similar principle applies in the case of other types of overhead expenses incurred in developing property, such as administrative costs of the developer or builder, or lawyers' fees and other expenses incurred in connection with obtaining zoning approval or building permits. In other words, the 10-percent test is to be applied by taking only the direct construction costs into account.

In determining whether 10 percent of construction has been completed, generally the property is to be examined building-by-building. For example, if a REIT acquires on foreclosure a project where two identical apartment buildings are being constructed on one piece of land, if one apartment is 80 percent finished and the other apartment is less than 10 percent finished, the REIT could complete the construction of the first building, but could not complete work on the second building. On the other hand, if an integral part of the first apartment building was a garage not yet begun at the time of foreclosure, the REIT would be able to have the garage constructed (if the garage

and building considered together as one unit were more than 10 percent completed).

Likewise, where the REIT has foreclosed on land held by a developer building a housing subdivision, the REIT could complete construction of the homes where more than 10 percent of the construction had already been completed, but could not begin construction of other homes in the subdivision.

The 10 percent rule applies to the amount of construction completed before default became imminent. This time period is used in order to prevent last minute increases in the amount of construction in order to push the construction over the 10 percent limit, where it is clear that foreclosure will take place.

Since the 10 percent limit with respect to construction applies only to foreclosure property, to the extent that present law allows construction to be undertaken by a REIT it may do so where it acquires property on foreclosure, but does not elect to have the property treated under the new foreclosure rules of the bill.

Property used in a trade or business.—This bill also provides that if a REIT acquires, through foreclosure, real property which is used in a trade or business, the REIT is not to conduct the trade or business itself but is to use an independent contractor. Thus, if a REIT acquires a hotel on foreclosure, the REIT is to operate the hotel through an independent contractor during the grace period. However, the REIT is given 90 days to hire an independent contractor, and thus may itself operate the hotel for 90 days after acquisition on foreclosure. By requiring an independent contractor to operate a trade or business acquired on foreclosure, the bill preserves the REIT's basic character as a passive investment medium.[5]

Extensions of time.—If a REIT elects to have property treated as foreclosure property, it will be treated in this manner for two years after the date of acquisition on foreclosure by the REIT. Thus, a REIT initially is given two years to negotiate new leases and change the type of income received from foreclosure property from nonqualified to qualified income, or two years to dispose of the property.

If two years is not sufficient, extensions of time may be granted. The two-year period may be extended twice, and each extension may be up to a year, if the REIT establishes to the satisfaction of the Internal Revenue Service that an extension is necessary for the orderly liquidation of the trust's interest in the property (or an orderly change in the terms and conditions of leases on the property). It is expected that extensions will be granted in cases of significant difficulties in disposing of the property or in changing the type of income. The burden is to be on the REIT to show that good faith efforts have been made before applying for the extension to correct the situation resulting from the foreclosure.

Taxation of income from foreclosure property.—If a REIT elects to have real property treated as foreclosure property, all of the nonqualified income from that property is to be subject to tax. The REIT is to pay tax on this income as if it were a corporation subject to tax under section 11. The tax rate generally is to be the corporate tax rate,

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[5] Under the bill, "independent contractor" is defined in the same way as under present law. See Regs. 1.856-4(b)(3)(i)(b).

without the surax exemption. On the other hand, any qualified income received from the foreclosure property would, of course, not be subject to tax (provided that it was distributed to the REIT's shareholders).

The income which is to be taxed under the bill is the gross income received from the foreclosure property which is not qualified under the 75 percent income source test (such as "bad" rents or income derived from the sale or other disposition of property held primarily for sale) less the direct (but not the indirect) expenses attributable to the production of this income. For example, if 100 percent of REIT's income prior to foreclosure qualified for the 75 percent income source test (and, therefore, also for the 90 percent test), but after foreclosure 11 percent of a REIT's income was converted to income from "bad" rents, then, if the REIT elected to use the foreclosure rules, it would continue to remain qualified, but the 11 percent of its income would be taxable. The direct expenses of earning this income would be deductible, but indirect expenses (including the general overhead and administrative costs of the REIT) would not be deductible.

All of the income from foreclosure property (whether or not otherwise qualified) will be treated as qualified income for purposes of the 90 percent and 75 percent income source tests.[6] Therefore, if a REIT has 10 percent of gross income sources, the REIT will not be disqualified if it receives additional nonqualified income from foreclosure property.

Under thes bill, as noted above, tax is imposed only on nonqualified net income from foreclosure property, and is not imposed on qualified income from that property. In this way, a REIT will be encouraged to change the type of income it receives from foreclosure property to qualified income.

Following the current requirement that a REIT act as a conduit of income, the bill also provides that 90 percent of net income from foreclosure property (in excess of the tax on such income) is to be distributed under the rules of present law.

Foreclosure property is to be treated as any other property for purposes of determining if the 75 percent (and 25 percent) assets tests are met. Since foreclosure property generally will be real property, it generally will qualify for the 75 percent test.

Foreclosure property held for sale.—Present law prohibits a REIT from holding any property for sale to customers. Under the bill, this rule is modified to allow a REIT to hold foreclosure property for sale. This is necessary to allow a REIT to sell off property that it inadvertently acquired on foreclosure. Any income from the sale of this property (less direct expenses of the sale) is to be taxed to the REIT at corporate rates. As with other foreclosure income, 90 percent of this net after-tax income is to be distributed to shareholders.

The committee recognizes that the holding-for-sale rule in general has caused problems for REITs. For example, questions have been raised with regard to whether income from specific transactions constitute holding-for-sale income in the context of a real estate investment trust. This is part of the overall problem that under present law

[6] This income will be included in both the numerator and denominator of the fractions. Of course, income from foreclosure property will not be treated as qualified income to the extent that it is derived from sources which produced unqualified income for the REIT prior to the foreclosure.

if a REIT does not meet the various income, asset, and distribution tests, the REIT will be disqualified from using the special tax provisions even in cases where the failure to meet a requirement occurred after a good faith, reasonable effort on the part of the REIT to comply. Disqualification would have the effect of not only changing the tax status of the REIT itself, subjecting its income to tax at corporate rates, but also could adversely affect the interests of the public shareholders of the REIT. These problems are numerous and complex, and consequently the committee does not believe that this is the appropriate time to consider these questions. However, the committee believes, and intends, that these problems should be addressed early in the next Congress.

Effective date.—These provisions are to apply to foreclosure property acquired after December 31, 1973.

Revenue effect.—The revenue effect of these provisions is believed to be negligible.

F. INCREASE IN INTEREST CHARGED AND PAID FROM 6 PERCENT TO 9 PERCENT

(Sec. 7. of the bill and secs. 514, 6601, 6602, 6611, 6332, 6654, 6655, 7426 of the code and sec. 2411(a) of title 28 of the U.S. code)

In general, interest is payable by a taxpayer to the Government if the taxpayer fails to pay a tax on time (disregarding extensions) and, likewise, the Government will pay interest to a taxpayer if the taxpayer overpays his tax and the overpayment is not refunded within 45 days from the date when the return is due or, if later, the date when the return was filed. The interest rate is generally 6 percent per year.

Under present law a 6 percent annual interest rate also applies to any personal liability of a taxpayer who fails or refuses to surrender any property (or rights to property) on which a levy has been made (sec. 6332(c)(1)); to erroneous refunds recovered by the Internal Revenue Service (sec. 6602); and to certain wrongful levies by the Government on money or other property of a person other than the taxpayer (sec. 7426(g)).

There are a number of special situations under present law where a 4 percent annual interest rate, rather than 6 percent, is paid. Under present law the estate tax attributable to a closely held business included in a decedent's estate may be paid in ten annual installments if the business constitutes a large portion of the estate, subject to certain qualifications (sec. 6166). Payment of the estate tax may also be extended at an executor's election where the tax is imposed on the value of a reversionary or remainder interest included in the gross estate (sec. 6163). Further, if the Internal Revenue Service determines that payment of any part of the estate tax on any due date would impose undue hardship on the estate, extensions of time for payment may be granted (sec. 6161(a)). In each of these instances interest is payable at the rate of 4 percent per year (sec. 6601(b)).

A 4 percent interest rate also applies under present law to an extension of time to pay tax attributable to recovery of a foreign expropriation loss (sec. 6601(j)), and to refunds or credits for overpayments of tax on unrelated business income by an exempt organization under the so-called "neighborhood land rule" (sec. 514(b)(3)).

Most taxpayers are subject to withholding of tax on their salary or wages by their employers. If a taxpayer is not subject to withholding on his income or withholding is not sufficient to cover his tax liability, the taxpayer is required to make an estimate of his tax liability and make timely installment payments. In the case of an underpayment of an installment of estimated tax, an addition to the tax is imposed at an annual rate of 6 percent. The amount to which the 6 percent rate applies is the difference between the payment (if any) made on or before the due date of each installment and 80 percent (66⅔ percent in the case of farmers or fishermen) of the payment which would be due on the basis of the taxpayer's final tax on his annual return.

The present addition to tax on underpayment of estimated tax by a corporation is also 6 percent. A 6 percent addition to tax also applies to an excessive credit or refund claimed by a corporation (sec. 6655 (g)).

Historically the 6 percent tax interest rate has been higher than the prevailing money market interest rate. The 6 percent rate on refunds has been in effect since 1921, and the 6 percent rate on underpayments or nonpayments of tax has remained unchanged since 1935. By way of comparison, in 1935 the average rate of interest on grade Aaa corporate bonds was 3.6 percent, or roughly 60 percent of the tax interest rate. The purpose for this differential was to provide an incentive for the taxpayer to pay his tax promptly and for the Government to credit or refund overpayments promptly. However, money market rates are currently (and for several years have been) at significantly higher levels than 6 percent. During the period 1969–1973, the average interest rate on grade Aaa corporate bonds ranged from just over 7 percent (in 1969) to just over 8 percent (in 1970). The average rate for 1973 was 7.44 percent and in the latter part of 1974, it has been in the neighborhood of 9 percent. There is little expectation that commercial interest rates will return to a rate lower than 6 percent in the foreseeable future. As a result, the present statutory interest rate no longer serves the purposes for which it was originally intended.

An increasing number of taxpayers are finding it more profitable to "borrow" tax funds at the present 6 percent rate rather than paying their taxes when due, and rather than using their own funds or borrowing funds at prevailing commercial rates. The present rate may also encourage taxpayers to claim more questionable deductions or other tax reducing items than they otherwise might, on the theory that a later disallowance will ony "cost" 6 percent. The trend in taxpayer postponement of tax payments is indicated in the fact that delinquent individual and business tax accounts totaled 2.8 million in 1973, an increase of approximately 400,000 over 1972. The dollar value of these delinquent accounts was approximately $5 billion, an increase of $1.5 billion, or 40 percent, over corresponding 1972 amounts. As a result of these developments, the committee believes that the interest rate should be increased to 9 percent per year and kept in line with money market rates in the future.

In those cases where the 4-percent interest rate applies, although an extension of time to pay a tax may be appropriate in certain cases in order to avoid unnecessary hardship, the committee sees no sound reason to permit some taxpayers to pay interest at a lower rate than

other taxpayers are required to pay on underpayments of tax. Relief from the hardship of paying taxes in a lump sum should not also mean that the interest rate should be reduced if payments are made in installments. This is particularly so if a closely held business owned by an estate, or a business which has recovered an expropriation loss, is or can be earning a significantly higher return on the tax money which it presently can, in effect, borrow from the Government at 4 percent.

On the other hand, where a taxpayer is entitled only to 6 percent interest (or 4 percent in some cases) under present law on a refund or credit relating to an overpayment of tax, he is not receiving the value he could obtain by the use of his own funds. Moreover, since the Government must pay more than 6 percent for money, the incentive to make refunds promptly is no longer operative. For these reasons, the committee believes that this interest rate should be updated to 9 percent and kept in line with interest rate movements as well.

The increased interest rate is intended as a practical approximation or composite rate, and is not designed to reflect every money market factor which annually affects interest rates, such as the degree of risk or the demand or supply of loanable funds, etc. While the committee does not expect interest rates to decline to the area of 6 percent or increase to much higher levels in the foreseeable future, it is concerned that subsequent declines or increases in interest rates could create a significant gap between the 9-percent rate (as provided by the committee amendment) and prevailing money market rates. In order to avoid in the future the present wide gap between the interest rate charged on tax refunds and tax deficiencies and the prevailing money market rate (that has occurred over a long period of time when no adjustment in the interest rate on taxes was made), the committee concluded that it is appropriate to provide for a periodic, semi-automatic adjustment of the interest rate on tax payments to reflect significant changes in money market rates. For this purpose, the committee concluded that the prime lending rate which banks quote on short-term loans to large businesses is the appropriate money market rate to use as a guideline for adjustments, since it is sensitive to money market conditions and is widely known and accepted as a good indicator of interest rates generally.

Under the bill the present 6-percent rate on tax overpayments and underpayments, on underpayments of estimated tax by individuals and corporations, and on excessive adjustments of overpayments of estimated tax by a corporation, is increased to 9 percent. The bill also amends the United States Code (28 U.S.C. sec. 2411(a)) to increase from 6 to 9 percent the interest rate to be paid by the Government on a judgment for any overpayment of tax. A similar increase to 9 percent is also provided in the case of personal liability resulting from enforcement of a levy, recovery by the Government of an erroneous refund and recovery by certain persons of property on which a wrongful levy was made.

In addition, in those cases where the special 4-percent interest rate applies, the bill also increases the rate to the general 9-percent rate. Thus, in cases where the time for payment of an estate tax (either at the executor's election or in hardship situations) has been extended, or

the time to pay a tax attributable to recovery of a foreign expropriation loss has been extended, interest at the rate of 9 percent per year must be paid on the unpaid balance of the tax and on the unpaid balance of any deficiency in the tax prorated to the installments. The 9-percent interest rate will also apply to refunds or credits for overpayments of tax by a charity on unrelated business income under the neighborhood land rule.

The bill provides that the 6-percent interest rate is to be increased to 9 percent for liabilities outstanding after July 1, 1975. This delay is to permit the Internal Revenue Service to revise its procedures and publications to take into account the new interest rate. Subsequently, the 9-percent rate is to be increased or decreased to keep it approximately equal to 90 percent of the prime rate (the current relationship of the new 9 percent rate with the prime rate of slightly over 10 percent). The 9-percent rate is, therefore, to become an "adjusted rate." This is done in the bill by providing an "adjusted prime rate" which is to be 90 percent of the prime rate. Under the bill the basic 9-percent rate will be changed if the adjusted prime rate is at least a full percentage point more or less than the interest rate then in effect (9 percent or whatever the subsequently modified rate may be). Thus, if the prime rate at the first adjustment period were to drop to 8 percent, the 9 percent would be reduced to 7 percent (90 percent of 8 percent rounded downward to the 7 percent rate according to the general rounding rule of one-half and over is rounded up and less than one-half is rounded down—a rule to ease the administrative complications of fractional rates).

The prime rate for this purpose is the predominant prime rate quoted by commercial banks to large businesses as regularly published by the Board of Governors of the Federal Reserve System. The review of the prime rate is to be made by the Secretary of the Treasury or his delegate based on the average rate for the month of September, announced by him on or before October 15, and made effective as of the following February 1 so that sufficient lead time will be available for taxes due on March 15 or April 15. Thus, the first change in the 9-percent rate could be made for February 1975. To prevent excessive adjustments in the interest rate which would present administrative problems for the Internal Revenue Service, a change in the rate cannot be made more often than once every 23 months. If the first change was made in October 1974 for February 1975, the next change could not be made before October 1976 applicable to February 1977.

Apart from increasing the rate of interest and the rate of additions to the tax, the bill does not change any substantive rules under present law relating to interest or to additions to the tax.

Effective date.—The amendments made by this provision take effect on July 1, 1975. The increased rates apply to a tax liability which initially arises on and after July 1, 1975, and to a liability which arose before that date and continues outstanding in part or whole thereafter (but only on the portion that remains outstanding after July 1, 1975). The 4- or 6-percent interest rate (as the case may be) under present law will continue to apply to interest accruing up to July 1, 1975.

Revenue effect.—The estimated increase in receipts from this increase in interest rates is $130 million in calendar year 1975, $300 million in 1976, and $330 million in 1977.

G. TAX TREATMENT OF CERTAIN STUDENT LOAN FUNDING PROGRAMS

(Sec. 8 of the bill and sec. 103 of the code)

Under present law (sec. 103(a) of the code), interest paid on certain governmental obligations is exempt from Federal income tax. These obligations are, in general, those of the Federal Government, States and their political subdivisions, and of certain corporations organized under an Act of Congress as instrumentalities of the United States.

Present law, however, does not extend this tax-exempt status to what are referred to as "arbitrage bonds." These bonds which are used by State or local governments where all, or a major part, of the proceeds can be reasonably expected to be used (directly or indirectly) to acquire securities or obligations which may be reasonably expected, at the time of the issuance of the State or local obligation, to produce a yield which is higher than the yield on the State or local government bond issue.

The committee has been informed that certain student loan programs which are financed by nonprofit higher education authorities, rather than by political subdivisions of the State, do not qualify for tax-exempt status for bonds issued to finance student loans. This is because in certain States political subdivisions apparently do not have the governmental authority to issue bonds to finance their student loan programs and, as a result, certain organizations are created for this purpose. These organizations, although established pursuant to State law, are not political subdivisions of the State and, therefore, the obligations they issue are not exempt under section 103(a).

In addition, the committee understands that in certain cases even if these obligations were to qualify under section 103(a), they would nevertheless not be exempt because they would be treated as arbitrage bonds (under sec. 103(d) of the code). This is because of the provisions in the Emergency Insured Student Loan Act of 1969. This Act provides that the Commissioner of Education (of the Department of Health, Education, and Welfare) is authorized to provide incentive payments to institutions providing student loans. Although the maximum rate of interest to be paid by students on their loans is now set at seven percent, this yield, together with the incentive payments received by the institution making the loan from the Commissioner of Education, will constitute a yield that should be higher than the maximum yield the associations believe they will be able to pay on their bonds if they are to cover administrative expenses and maintain a solvent loan program. As a result, these bonds would be subject to the arbitrage bond provision and, thus, would not be entitled to tax exemption.

Although the Treasury temporary regulations (Regs. § 13.4(b)(3)(ii)(b)) provide, in general, that a bond issue is not to be classified as an arbitrage issue if the yield from the intended program will not exceed the yield from the governmental issue, *plus* administrative expenses, this rule further provides that administrative expenses may be taken into account for this purpose only if they are not payable with funds appropriated from other sources. In cases where the bonds are general obligation bonds and a State legislature is required to appro-

priate the funds necessary to pay the administrative expenses, as well as the principal of and interest on the bonds, if the program fails to generate the necessary revenue, the expenses would be "payable from other sources" and as result such bonds not meet the regulation's requirements. This means that they would be treated as arbitrage bonds.

The provision added by the committee amendment includes in the list of exempt obligations described in section 103(a) of the code certain qualified scholarship funding bonds. These are defined as obligations issued by a corporation which is nonprofit and is established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965. In addition, the corporation must be organized at the request of the State or political subdivision and must be required by its corporate charter and bylaws (or required by State law) to devote any income, after the payment of expenses and debt service, to the purchase of educational student loan notes or to pay over any income to the State or political subdivision. As a result of this provision, a nonprofit corporation which meets these requirements will qualify to issue tax-exempt bonds to finance student loan programs.

In addition, the arbitrage provision (sec. 103(d) of the code) is amended to make it clear that the student loan incentive payments made by the Commissioner of Education under the Emergency Insured Student Loan Act of 1969 are not to be taken into account in determining whether the yield on the student loan notes is higher than the yield on the bonds issued to finance the student loan program. As a result, these obligations issued to finance student loan programs will not be treated as arbitrage bonds.

Effective date.—The amendments made by the committee amendment will apply to obligations issued on or after the date of enactment.

Revenue effect.—The revenue loss from this provision is estimated at less than $1 million in 1975 and in 1976 and between $1 million and $2 million in 1977 if the associations that finance the student loan programs under this provision are limited to those the committee understands are in the planning stage. If formation of similar associations became more widespread, the revenue loss could be substantially larger.

11. EXCLUSION FROM GROSS INCOME OF U.S. BANK DEPOSITS HELD BY NONRESIDENT ALIENS

(Sec. 9 of the bill, and sec. 861 of the code).

Present law provides, in general, that interest, dividends, and other similar types of income of a nonresident alien or a foreign corporation are generally subject to a 30-percent tax on the gross amount paid [1] if such income or gain is not effectively connected with the conduct of a trade or business within the United States (sec. 871(a) 881).[2] However, interest from deposits with persons carrying on the banking business, from deposits or other accounts with savings and

[1] This tax is generally collected by means of a withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442).

[2] If the interest, dividend or other similar income is effectively connected with a U.S. trade or business, that income is included in the normal income tax return which must be filed for the business.

loan institutions or other similar associations, and from amounts held by an insurance company under an agreement to pay interest are exempt under a provision which expires after December 31, 1975 (sec. 861(a) and 861(c)). In addition, for these types of debt obligations and deposits no U.S. estate tax liability is assessed if, upon the decedent's death, any interest received would be exempt from withholding tax (sec. 2105(b)).

The exemption for bank deposits and other similar types of deposits and debt obligations has aided in attracting substantial amounts of funds to the United States. Most of these funds are placed in certificates of deposits having a duration of 12 months or longer. Since the present exemption is to expire on December 31, 1975, it is understood that may of these one year certificates of deposits may not be renewed during 1975 unless the foreign depositors receive some assurance that the interest exemption will be continued.

For this reason, the committee has agreed to extend the termination date for the exemption for one additional year until December 31, 1976. Thus, interest on bank deposits and other similar types of deposits and debt obligations presently exempt from withholding tax will continue to be exempt through 1976. As a result of this extension, these deposits and debt obligations will also continue to be exempt from estate tax through the end of 1976.

The committee takes this action as an emergency measure to prevent during 1975 an outflow of funds held as certificates of deposits with U.S. savings institutions. The committee intends in the next Congress to review the withholding tax provisions for all types of interest obligations, as well as for other types of investments, and at that time to reach more comprehensive conclusions regarding U.S. tax policies affecting all such types of investments.

The amendments extending the exemption for bank deposits and other similar types of deposits and debt obligations are to be effective as of the date of enactment of this bill. Since these items are exempt under present law, the extension of this provision does not result in any additional revenue loss.

I. CERTAIN INTEREST EQUALIZATION TAX OBLIGATIONS

(Sec. 10 of the bill and secs. 861(a)(1) and 2104(c) of the code)

The interest equalization tax (IET) contained a procedure whereby U.S. obligators could borrow money from foreign lenders without the foreign lenders being subject to the 30-percent withholding tax on interest or any U.S. estate tax. This procedure was accomplished by the U.S. obligor electing to subject its obligations to the IET (sec. 4912(c)). Furthermore, in order to permit U.S. companies to simplify their existing international financing structures, companies were permitted to use this procedure for outstanding obligations of an affiliated corporation by having the domestic parent assume those obligations. Those provisions are no longer applicable since the IET expired on June 30, 1974. However, obligations which were made subject to this IET procedure continue to receive the interest withholding and estate tax exemptions (secs. 861(a)(1)(G) and 2104(c)).

The purpose of this procedure was to enable companies to simplify their international financing operations by eliminating foreign or domestic financing subsidiaries which they were otherwise required to maintain. However, the requirement that the U.S. corporation assume the obligations of its finance subsidiary has prevented some companies from fully utilizing this procedure, since the change in interest rates would cause the finance subsidiary to realize income from discharge of indebtedness upon the assumption. These companies have been forced to retain the financing structures they established to satisfy the IET. Accordingly, the committee's bill provides U.S. companies which were entitled to make the IET election may make the interest paid on that obligation exempt from withholding tax.

The committee's bill limits this procedure to any issue of indebtedness outstanding on the date of the enactment of the Interest Equalization Tax Extension Act of 1971 if it was guaranteed by a U.S. person and was treated under that Act as a debt obligation of a foreign obligor. In addition, as under the requirements of existing law (sec. 861(a)(1)(G)) the obligation may not have a maturity date exceeding 15 years as of June 30, 1974, and when issued the obligation must have been purchased by one or more underwriters with the purpose of distribution through resale. Obligations the interest from which are exempt from tax under this provision are excluded from property in a foreign person's gross estate for estate tax purposes.

The income tax amendment applies to interest paid after date of enactment and the estate tax amendment applies to estates of decedents dying after the date of enactment. Since these obligations are presently held by financing subsidiaries and are treated as foreign obligations, the interest paid on them is presently not subject to U.S. withholding taxes. Thus, the enactment of this provision does not result in a revenue loss.

J. POLITICAL ORGANIZATIONS

1. Taxation of Political Parties and Committees (sec. 11 of the bill and sec. 527 of the Code)

Until recently, the tax status of political organizations has been somewhat uncertain. Historically, the Internal Revenue Service has not generally required the filing of income tax returns by political organizations.[1] Presumably, this practice resulted from the belief that virtually all of the receipts of political organizations were from gifts and that these organizations would not have taxable income. However, in 1968 the Internal Revenue Service announced that investment income of a political campaign fund constitutes gross income and may be reported on a fiduciary tax return, (Form 1041) with the tax due thereon paid with the filing of the return. Recently, as a result of the increasing practice of individuals making political contributions in the form of appreciated property, the Internal Revenue Service conducted a study of the tax consequences relating to these transactions. This study also included the tax status of political organizations in general.

On August 1, 1973, after conducting public hearings on these questions, the Internal Revenue Service announced that political parties

and committees are taxable organizations and must pay tax on interest, dividends from investments, income from ancillary commercial activities, and gains from sales of appreciated property. In its subsequent ruling, the Service stated that campaign contributions are not includable in gross income and that expenditures for political purposes and expenses incurred for fund-raising activites are not deductible. On the other hand, expenses directly attributable to activities undertaken for the production of income which is taxable (interest, dividends, etc.) are deductible. Expenses attributable to the sale of appreciated property are to reduce gross proceeds in determining gain or loss realized on the sale. Under the ruling, political organizations may be treated as corporations, trusts, or possibly partnerships depending upon the facts and circumstances of the individual organization.

The Service also has ruled that political organizations with taxable incomes of $100 or less are not required to pay taxes or file returns for taxable years beginning before January 1, 1975.

Because the questions involved in this area require a delicate balance between the need to protect the revenue and of the need to encourage political activities which are the heart of the democratic process, the committee has examined the entire problem of the tax treatment of these organizations.

In general, the committee's bill provides that political organizations are to be treated as tax-exempt organizations, since political activity (including the financing of political activity) as such is not a trade or business which is appropriately subject to tax. However, where assets are not currently used by a political organization for political activities, but are invested for use at a later date, the income from the investment (less direct expenses incurred in earning that income) is to be subject to tax.

Political organizations.—Under the bill, special tax treatment is provided for political organizations which are organized and operated primarily for accepting contributions or making expenditures for activities related to the election, etc., of candidates for public or party office. The organizations that qualify for this treatment may include political parties, committees, associations, funds (including the trust of an individual candidate), or similar political organizations. A qualifying organization may be formally established under articles of incorporation, a charter, etc.; however, it is also anticipated that such an organization may be established informally.

To be treated as a political organization for tax purposes, the organization must be operated primarily to receive money or make expenditures for influencing or attempting to influence the selection, nomination, election, or appointment of individuals for Federal (or

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[1] In a news release issued on October 3, 1972 (IR–1257), the Internal Revenue Service stated, "It is a matter of history that the Internal Revenue Service has never required the filing of income tax returns by political parties as such." However, it appears that the Government took a contrary public position on at least one occasion, in attempting to sustain an asserted income tax deficiency against the Communist Party. In that case (*Communist Party of the U.S.A.* v. *Commissioner,* 373 F.2d 682 (CAD.C., 1967)), the Court of Appeals stated that "the Government now assures us that all political parties, including petitioner[1] are taxable associations under the statute. That may be, but the Tax Court did not so rule; and petitioner is entitled to an adjudication in that court of its contention that the statute is not to be construed because the Commissioner and his predecessors have never so construed it." [Footnote omitted.] The case was remanded to the Tax Court; but the Government conceded virtually all of the asserted tax, and so the Tax Court never ruled on this question. The committee is not aware of any other instances in which the Internal Revenue Service has attempted to require a political party, as such, to file a Federal income tax return or to pay a Federal income tax.

regional), State (including D.C.), or local public office or for office in a Federal (or regional), State (including D.C.), or local political organization. It is recognized that between elections a political organization, such as a local political party, may not be supporting any specific candidate for election. In such a case, where the organization is engaged in activities that are related to and support the process of selection, nomination, election, etc., of candidates, it is to meet the operational test. For example, a local party that, between elections, prepares for the next party convention, engages in fund raising, transacts intraparty organizational business, etc., is engaged in qualifying activities. In addition, where an organization is established for a single campaign, it may continue to qualify after the election in order that it may wind up the campaign, pay off debts, put records in order, etc.

To qualify, an organization's activities must primarily involve receiving campaign contributions or making campaign expenditures. However, the organization need not engage in both raising and expending money.

It is expected that if an organization qualifies for purposes of the tax credit (or deduction) for political contributions, it will also qualify as a tax-exempt political organization. However, to qualify as a tax-exempt political organization, an organization does not have to be exclusively political. Thus, a local political club could carry on incidental social activities as long as it was organized and operated primarily to receive campaign contributions or make campaign expenditures. Similarly, a qualified organization could support the enactment or defeat of a ballot proposition, as well as support or oppose a candidate, if the latter activity was its primary activity.

An organization may qualify as a political organization if it indirectly receives or expends money for campaign purposes. For example, if a national organization receives political contributions indirectly through local organizations, it would be indirectly accepting contributions and would qualify under the bill. Similarly, a national organization that transfers money to local organizations for campaign expenditures would be indirectly making campaign expenditures. The committee expects that in such a case the national organization will take such care as is reasonable under the circumstances to see that the money transferred to the local organizations is spent for campaign purposes.

Exempt income.—Under the bill, a political organization is not to be taxed on the receipt of "exempt function income," including contributions of money or other property, or the receipt of membership fees, dues, or assessments from members of the organization. Whether a transfer of money or property constitutes a "contribution" is to be determined under present law (sec. 271(b)(2)). Generally, individual contributions of cash or property whether solicited personally or by direct mail will qualify as "contributions". However, in order to be exempt from tax, these amounts must be segregated in separate accounts to be used solely for nomination, etc. If contributions, etc., are received for campaign purposes, but are not segregated for such purposes, they will not be treated as exempt income. The income tax consequences of any diversion of segregated funds from campaign purposes are to be the same as under present law.

The committee also intends that filing fees paid by a candidate directly or indirectly to a political party in order that he may run in the primary election of that party (or run in the general election as a candidate of that party) are to be treated as exempt contributions. For example, some States provide that a certain percentage of the first year's salary of the office sought must be paid to the State as a filing (or "qualifying") fee and party assessment. The State then transfers part of this fee to the candidate's party. In such a case, the entire amount transferred to the party is to be treated as exempt function income, not taxable to the party. These filing fees also would be treated as contributions if the political party itself made the assessment and directly collected the money. In addition, to the extent that political organizations receive Federal, State, or local funds under the $1 "checkoff" provision or any other provision for public financing of campaigns, these amounts are to be treated as tax-exempt contributions.

Under the bill, political organizations are not to be taxed on proceeds received from political fund raising or political entertainment events, or proceeds from the sale of political campaign materials which are not received in the ordinary course of any trade or business. Thus, proceeds received from casual sporadic fund raising events or political entertainment events, such as an annual political dinner or an annual athletic exhibition, are to be treated as exempt function income. Similar fund raising events would include political breakfasts, receptions, picnics, dances, etc. However, in all of these cases the income would be exempt function income only if the event is a political event and is not carried on in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business, for purposes of this section, are to include the frequency of the event; the manner in which the event is conducted; and the span of time over which the event is carried on. Whether an event is a political fund raiser or a political entertainment event will depend upon the facts and circumstances of the particular event, taking into account the extent to which the event is related to a political activity aside from the need of the organization for income or funds.

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

Other income.—Under the bill, all income received by political organizations. other than exempt function income, is to be subject to tax. A political organization's taxable income is gross income (excluding the exempt income described above) less deductions otherwise allowed that are directly connected with producing that gross income. The dividends received deduction and other special deductions for corporations are not to be allowed.

Indirect expenses (such as general administrative expenses) are not to be allowed as deductions, since it is expected that these amounts will be relatively small and eliminating these deductions will greatly simplify tax calculations.

The bill provides a specific deduction of $100 against gross income. As a result, a political organization is not subject to tax and is not required to file a return unless its gross income exceeds its directly connected deductions by more than $100.

The bill provides that a political organization is to be taxed on its nonexempt income as if the organization were a corporation. However, in order to avoid proliferation of a number of organizations no surtax exemption will be allowed. Also, the alternate capital gains rate for the corporations (30 percent, under sec. 1201(a)) is to be available for net capital gains income.

Exempt organizations which are not political organizations.—Under present law, certain tax-exempt organizations (such as sec. 501(c)(4) organizations) may engage in political campaign activities. The bill generally treats these organizations on an equal basis for tax purposes with political organizations. Under the bill, organizations which are exempt under section 501(a) and are described in section 501(c), that engage in political activity, are to be taxed on their net investment income in part as if they were political organizations. Thus, an exempt organization is to be subject to this tax if it spends any amount on the nomination, election, etc., of a candidate for public office, etc. However, these organizations are to be taxed only to the extent they actually operate as political organizations (that is, to the extent of their political expenditures). Therefore, if the amount expended for political purposes is less than the net investment income, the lesser amount is to be the tax base. The bill does not require "tracing" in this regard. Thus, the tax is to apply even though the organization uses its investment income exclusively for nonpolitical purposes and makes its political expenditures entirely out of funds other than its investment income.

To avoid double taxation (and double deductions), the bill provides that income and deductions taken into account for purposes of the tax on unrelated business income of such exempt organizations are not to be included as either income or deductions in determining net investment income under the political organization provisions.

It is not intended that the section 501(c) exempt organization be absolutely liable for any expenditures made by an organization to which it gives funds. However, if the payment is made for any of the political purposes described in this section, then the exempt organization is to be treated as having indirectly made the political expenditure. Also, if there are reasonable questions as to whether funds will be spent for political purposes and the exempt organization wisses to avoid imposition of the tax, it would be expected to take reasonable steps to see that the recipient organization does not spend funds for political purposes. In administering this provision, the Internal Revenue Service could, for example, provide that establishment of trust funds or other appropriate methods of segregating the payments will be satisfactory in demonstrating that indirect political expenditures do not result from the payment by the exempt organization.

The committee expects that, generally, a section 501(c) organization that is permitted to engage in political activities would establish a separate organization that would operate primarily as a political organization, and directly receive and disburse all funds related to nomination, etc., activities. In this way, the campaign-type activities would be taken entirely out of the section 501(c) organization, to the benefit both of the organization and the administration of the tax laws.

Under present law (section 610 of title 18 of the United States Code), a corporation or a labor organization which is otherwise forbidden to make contributions or expenditures in connection with Federal elections to public office or to political party office, may nevertheless establish a "separate segregated fund" which is maintained by the corporation or labor organization. The separate segregated funds is permitted under the statute to be utilized for political purposes.

For purposes of the rule in this bill regarding the treatment of exempt organizations (and for purposes of the definition in this bill of "political organization"), a separate segregated fund maintained by an exempt organization (a labor union described in sec. 501(c)(5), a chamber of commerce, etc., described in sec. 501(c)(6)), is to be treated as an entity which is separate from the exempt organization maintaining the fund. In such a situation, where the contributions are collected by employees of the exempt organization and are placed directly into the accounts of the separate segregated fund, these contributions are not to be treated as having come from the exempt organization. The amount subject to tax on account of those contributed amounts is to be measured by the political organization taxable income and the capital gains of the separate segregated fund in the same manner as other political organizations, and not by the income of the exempt chamber of commerce or labor union.

The committee understands that, in a number of States, exempt chambers of commerce and labor unions may establish funds similar to the section 610 separate segregated funds. Although the requirements as to the manner of collection of contributions in those States, for State elections, may be somewhat different from the requirements under Federal law with regard to Federal elections, where the State statutes are similar to the Federal in this respect, then the separate segregated funds or their equivalents are to be treated the same as the section 610 separate segregated funds for purposes of this bill. In such a case, if the exempt organization technically receives the contributions or dues but the exempt organization does not receive any interest, etc., income on those contributions or dues and promptly transfers the contributions or dues to the separate segregated fund, then the chamber of commerce or labor union is to be treated as not having made a political expenditure of those contributions or dues.

This provision is not intended to affect in any way the prohibition against certain exempt organizations (e.g., sec. 501(c)(3)) engaging in "electioneering" or the application of the provisions of section 4945 to private foundations.

Disposition of unexpended funds.—Under the bill a political organization may contribute any amount to or for the use of another

(qualified) political organization. Such a transfer is not to affect the tax status of the transferor organization, and the transfer is not to be treated as a diversion of funds for the personal use of the candidate, the governing board, or any other person. (Newsletter funds are to be treated somewhat differently—see below.) Similarly, a political organization may transfer funds to the general fund of the U.S. Treasury or of any State (including D.C.) or local government or to or for use of an exempt "public charity" (i.e., an organization which is exempt under sec. 501(c)(3) and is not a private foundation or an organization described in sec. 509(a) (3) or (4)). Since no one is to realize income on such a transfer, no deduction is to be allowed to the political organization or to any other person on account of a transfer to a charitable, etc., organization.

As under present law, when amounts are diverted from a political organization by a candidate for his personal use, the amount diverted is taxable income to the candidate in the year in which the funds are diverted.

If the payment satisfies a legal obligation of the candidate, then it may be treated as a diversion for his personal use. For example, if the candidate uses amounts from his campaign fund to pay his Federal income tax, then this is treated as a diversion, even though the amount is deposited "in the general fund of the Treasury." Similarly, use of a campaign fund to satisfy a legally binding pledge to make contributions to a public charity is to be treated as a diversion. In such a case, the candidate would include the diverted amounts in his gross income. In the illustration relating to Federal income taxes, there would be no offsetting deduction; in the illustration relating to charitable contributions, there would be an offsetting charitable contributions deduction (assuming that the candidate was itemizing his deductions and that the applicable deduction limits (the 50-percent, 30-percent, or, in the case of a contribution for the use of a "public charity," the 20-percent limit) were not exceeded).

Where unexpended funds are held by a candidate who dies, and these funds go to his estate or to his survivors, it is expected that the Internal Revenue Service will allow a reasonable period after death for these funds to be transferred to another political organization, charitable organization, or to the general fund of the U.S. Treasury, etc. However, the unexpended funds that are not so transferred constitute income of the decedent, since by arranging for the funds to go to his estate, the decedent will have exercised sufficient "control" to be in constructive receipt of the funds before death.

Under the bill, incidental amounts used by a political organization for the primary purpose of benefiting the candidate directly in connection with his campaign are not to be treated as amounts diverted for the personal benefit of the candidate. For example, self-improvement courses directly related to the campaign, such as voice and speech lessons, are not to be treated as diversions. Similarly, where a political organization pays for a candidate's transition expenses, these expenditures are not to be considered a diversion if the amount paid is reasonable.

2. Contributions to Political Organizations (secs. 13 and 14 of the bill and secs. 84 and 2501 of the Code)

Since 1932, the Internal Revenue Service has treated political campaign contributions as taxable transfers for purposes of the gift tax.[2] Under present law, a $3,000 annual exclusion from taxable gifts is allowed for each donee. The Internal Revenue Service has ruled that for gift tax purposes political organizations (and not the candidates they support) generally are considered the donees of political contributions. The Service has further ruled that each political organization, if it is organized and operated as a bona fide committee or organization, will generally be treated as a separate donee for purposes of the annual gift tax exclusion where the committees are the actual recipients of the contributions.[3]

As indicated, there is some uncertainty in the law as to whether political contributions are properly taxable as gifts. The committee believes that it is inappropriate to apply the gift tax to political contributions because the tax system should not be used to reduce or restrict political contributions. Consequently, the committee's bill provides that the gift tax is not to apply to the transfer of money or any other property to a qualified political organization, where the transfer occurs after May 7, 1974.

However, if a decedent includes a political organization as a beneficiary of his estate, the amount so transferred is to be included in his estate.

As previously discussed, it is the position of the Internal Revenue Service that campaign contributions are taxable transfers for purposes of the gift tax. As a result, in the case of gifts of appreciated property, the donee takes over the contributor's "basis", i.e., his tax cost, for income tax purposes and no gain is recognized by the donor at the time of the transfer. However, the committee's bill provides that the gift tax is not to apply to transfers to political organizations which occur after May 7, 1974. The committee also believes that it is appropriate to tax the contributor on unrealized appreciation on property transferred to political organizations. This rule is to apply solely to contributions to political organizations and is not to apply, nor is any inference to be drawn with respect to, contributions of appreciated property to other organizations such as charitable organizations.

Under the bill, if a person transfers property to an exempt political organization, and at the time of transfer the fair market value of the property exceeds its adjusted basis to the contributor, then the contributor is to be treated as having sold the property on the date of transfer. The contributor then is to be treated as having realized an amount equal to the fair market value of the property on the date of transfer. The sales price is deemed to be fair market value at the time

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[2] However, one court has held that, in the circumstances in the particular case, political contributions were not taxable gifts because they were motivated by a desire to protect and advance a taxpayer's personal and economic interests. *Stern* v. *United States*, 436 F.2d 1327 (CA5, 1971). The Internal Revenue Service has announced that it will follow the *Stern* decision only in the Fifth Circuit; in that circuit, the Service will follow that decision in "any case on all-fours with the *Stern* case." Rev. Rul. 72-583, 1972-2 CB 534.

[3] However, one U.S. district court has ruled that political contributons by one donor to multiple committees established to further the nomination or election campaign of the same candidate are not to be treated as gifts to distinct persons for purposes of the $3,000 annual gift tax exclusion, *Tax Analysis & Advocates* v. *Shultz*, 376 F. Supp. 889 (DC D C., 1974).

of contribution (rather than the proceeds received by the political organization on sale of the property) in order that the contributor may know what his tax liability is at the time he transfers the property. Since the property is to be treated as having been sold on the date of transfer to the political organization, the basis of the property to the organization is to be the basis to the transferor plus the amount of gain recognized to the transferor on account of the transfer. However, to avoid the selective recognition of losses by contributors, this provision does not apply where the fair market value of the property is less than its adjusted basis and the sale treatment would result in a loss to the contributee.

A transfer of appreciated property to a political organization generally is to be treated as a sale for all income tax purposes. Consequently, if gain on the sale would have been treated as ordinary income, it is to be taxed as ordinary income under this provision; if the gain would have been long-term capital gain, it is to be treated as long-term capital gain. Similarly, other provisions of the tax law, such as the minimum tax and recapture of depreciation, are to apply as if the property had been sold.

3. Newsletter Funds (secs. 11 and 12 of the bill and secs. 41, 218, and 527 of the Code)

At present, if an elected official receives contributions to a fund established to pay for his newsletter, the Internal Revenue Service treats the contributions as his income in the year received. Also, the amounts he spends in printing, addressing, etc., the newsletter are deductible as ordinary and necessary business expenses, so long as the elected official itemizes his deductions.

The committee believes that the present treatment of newsletter funds improperly affects the taxable income that must be reported by elected officials, since by reporting this income the individual's tax situation may be distorted. For example, since charitable contribution deductions cannot exceed a percentage of the taxpayer's adjusted gross income, inclusion of newsletter contributions in adjusted gross income could increase the charitable contribution deductions available to an elected official. By the same token, inclusion of newsletter contributions could increase the nondeductible "floor" for medical expense deductions, thereby decreasing the deductions available to the official. Also, if the individual does not spend the full amount he receives as contributions in the year received, newsletter income and deductions will not match each year, thereby increasing his income tax and reducing the amount available for newsletter purposes. Further, if an individual does not itemize his deductions he will not be allowed to deduct his newsletter expenses, thereby unfairly increasing his income tax.

In the usual case, it appears that income received by an individual from contributions to newsletter funds and the amounts paid out for expenses involved in publishing and distributing newsletters will be approximately equal over time. The committee believes that it is more appropriate not to tax the contributions received (and not to allow any deduction for expenses paid by the fund) for newsletters, to avoid the distortions of income described above. As a result, the bill provides

that a newsletter fund is to be treated in a manner similar to an exempt political organization. Thus amounts received for printing and distributing the newsletter are not to be taxed and deductions attributable to the newsletter are not to be allowed.

Taxation of newsletter funds.—Under the bill, if an individual establishes a fund to be used exclusively to prepare and circulate his newsletter, the fund is to be treated as an exempt political organization, as described above. This tax treatment is to be available for an individual who holds any Federal, State (including the District of Columbia), or local elective public office. It also is to be available for a person who is a candidate for such office, and to individuals who have been elected to public office, but who have not yet begun to serve in that office.[4]

To be eligible for this tax treatment, the assets in a newsletter fund must be maintained in separate accounts and must be used solely for the purpose of preparing and circulating the newsletter. The cost of preparation is to include (but not be limited to) the cost of secretarial services and the cost of printing, addressing, and mailing the newsletter.

Amounts received as contributions, membership (or subscription) dues, or proceeds from fundraising events for the newsletter fund are not to be treated as taxable income to the fund. However, any other income received by the fund, such as interest, dividends, and gain on the sale of appreciated property, is to be subject to the tax which applies to exempt political organizations. With respect to the taxation of such income, however, the $100 deduction allowed to political organizations is not to be allowed for newsletter funds. The committee believes that this is necessary to avoid proliferation of such funds.

A qualified newsletter fund is to be treated for most purposes as an exempt political organization. For example, contributions to a qualified newsletter fund are not to be subject to the gift tax. Transfers of appreciated property to such a fund are to be treated as sales to the fund by the transferor on the date of transfer. Unexpended assets may be transferred to certain charitable organizations, and to the general fund of the United States or of any State (including the District of Columbia) or local government, and the transfer is not to be treated as the diversion of amounts for the personal use of any person. However, it is intended that transfers are not to be allowed from a newsletter fund to a political organization which is not a newsletter fund since, to qualify, newsletter fund assets must be used exclusively for newsletter (and not campaign) activities. If assets of the newsletter fund are used for any purpose other than preparing or circulating the newsletter, contributions to certain charitable organizations, or transfers to the general fund of Federal, State (including the District of Columbia), or local governments, these amounts are to be treated as diverted for personal use and, therefore, taxable as under present law. Since activities of a newsletter fund are to be tax-exempt, it is intended that no deduction may be taken by the fund or by an elected

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[4] Of course, after an individual has completed his term of office, the newsletter provisions will not be available to him unless he again becomes a candidate.

official for newsletter expenses that are paid for with assets of the fund.

Tax credit for contributions to newsletter funds.—In the Revenue Act of 1971 (Public Law 92–178) Congress added a provision to allow an individual taxpayer a credit against his income tax liability (or an itemized deduction) for a limited amount of political contributions. This was done to encourage more widespread financing of political campaigns by small contributions. By encouraging small-scale contributions and broadening the base of political financing, these provisions were designed to help reduce the dependency of candidates on large contributors and special interest groups.

No similar credit or deduction is at present allowed for contributions to newsletter funds. However, the committee believes that the governmental process is strengthened by encouraging such contributions. It is vital that citizens know what their elected public officials are doing in office, so the voters can evaluate their performance for future elections and can tell their officials what they want them to do and not to do. Consequently, the committee has extended the existing credit and deduction provisions for political contributions to contributions to newsletter funds. Under this provision, the maximum annual credit or deduction allowed for political contributions and newsletter fund contributions together is limited to the amount available under present law, e.g., $12.50 credit or $50 deduction for an individual ($25.00 credit or $100 deduction in the case of a joint return).

4. Tax Credit or Deduction for Political, etc., Contributions (sec. 12 of the bill and sec. 41 of the code)

Under present law, a credit against tax (or a deduction from income) is allowed for political contributions to an individual or to a campaign committee supporting the individual only if the individual has publicly announced in the taxable year in question that he is a candidate for election. However, it is understood that for various reasons an individual may not wish to publicly announce his candidacy at an early date even though there is a substantial likelihood that he ultimately will become a candidate. Among the factors that may influence a decision to become a candidate is the willingness of a number of individuals to make small contributions to sustain a campaign. Accordingly, the bill provides that the tax credit (or deduction) for small political contributions is to be allowed to taxpayers if the individual publicly announced his candidacy before the end of the calendar year following the calendar year in which the contribution is made. For example, under the bill if a taxpayer makes a contribution to the "Elect X for Mayor Committee" in 1977, and X has not announced his candidacy, the taxpayer is to be allowed a credit (or deduction) for 1977 if X becomes a publicly announced candidate by December 31, 1978. The committee expects that the Internal Revenue Service will require appropriate verification in such cases that the individual has made a timely announcement of his candidacy.

Similar rules are to apply to political committees for such candidates.

5. Returns (sec. 11(b) of the bill and sec. 6012 of the code)

Under the bill every exempt political organization that has gross income (less deductions directly connected with the production of that income) in excess of $100 is to file a tax return for the years in which it has such income. The bill also provides that political organizations with $100 or less of such income need not file tax returns for years beginning after December 31, 1971, and before January 1, 1975.

6. Effective Dates

The provisions of the bill regarding the taxation of exempt political organizations and newsletter funds are to apply to taxable years beginning after December 31, 1974.

The provisions of the bill treating as a sale the transfer of appreciated property to a political organization, and the provisions eliminating the gift tax on such transfers, are to apply to transfer made after May 7, 1974.

The provisions of the bill extending the tax credit (or deduction) to contributions to newsletter funds, and allowing the tax credit or deduction for contributions to political campaigns in the year before a candidacy is publicly announced, are to take effect for contributions made after December 31, 1974, in taxable years ending after that date.

In addition, the bill provides that political organization does not have to pay tax on gains from the sale of contributed property if the sale occurred before August 2, 1973.

7. Revenue Effect

The estimated revenue gain in 1974 from the provisions taxing the donor on transfers of appreciated property to a political organization is expected to be less than $1 million; the estimated revenue gain in 1975 from the provisions relating to the taxation of political organizations and newsletter funds is expected to be less than $1 million; the estimated revenue loss in 1974 from the provisions excluding transfers to political organizations from the gift tax is expected to be less than $1 million; and the estimated revenue loss in 1975 from the provisions allowing an individual taxpayer a credit or deduction for contributions to newsletter funds is expected to be less than $1 million. In the aggregate, these provisions are expected to have a negligible revenue effect.

III. Costs of Carrying Out the Bill and Effect on the Revenues of the Bill

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs to be incurred in carrying out this bill and the effect on revenues of the bill.

Imports of upholstery regulators and upholsterer's regulating needles and pins, for which duty free treatment would be provided, are not separately classified, and, in the absence of import statistics, it is not possible to estimate accurately the amount of revenue loss. Based on information from firms supplying such articles to the upholstery

trade, it is estimated that annual imports of these articles would be less than $20,000. Therefore, it is estimated that the revenue loss resulting from this provision of H.R. 421 would be less than $2,000 during the first full year of its effectiveness.

Most of the tax provisions included in the committee bill are expected to have either no revenue effect or a negligible revenue effect. The only exceptions to this are the provision relating to the tax treatment of certain student loan funding provisions which is expected to result in a revenue loss of under $1 million in 1975 and 1976 and between $1 and $2 million in 1977, the four amortization provisions which are extended for one year which are expected to decrease revenues by $5 million in 1975, $4 million in 1976 and $3 million in 1977, and finally, the provision increasing interest rates charged and paid from 6 percent to 9 percent which are expected to result in revenue gains of $130 million in 1975, $300 million in 1976, and $330 million in 1977 (assuming the 9-percent rate remains effective in these 3 years).

IV. Vote of Committee on Reporting the Bill

In compliance with section 133 of the Legislative Reorganization Act, as amended, the following statement is made relative to the vote of the committee on reporting the bill. This bill was ordered favorably reported by the committee without a roll call vote and without objection.

V. 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).