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TAX REFORM ACT OF 1976

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 10612

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TAX REFORM ACT OF 1976

JUNE 10 (legislative day, JUNE 3), 1976.—Ordered to be printed

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

REPORT

[To accompany H.R. 10612]

The Committee on Finance, to which was referred the bill (H.R. 10612) to amend the Internal Revenue Code of 1954 to provide for reform and simplification of income taxes, to extend income tax reductions, to provide tax incentives for capital formation and energy development, to strengthen taxpayer rights, and for other purposes, having considered same, reports favorably with amendments and recommends that the bill as amended do pass.

I. SUMMARY

The Finance Committee amendment to the Tax Reform Bill of 1976 (H.R. 10612) is designed to achieve four objectives—

- to improve the equity of the income tax at all income levels without interfering with equally important goals of economic efficiency and growth,
- to simplify many tax provisions, delete unnecessary language and encourage taxpayers to use the standard deduction,
- to continue for the next 12 months the economic stimulus provided in the Tax Reduction Act of 1975 and extended through the first half of 1976 by the Revenue Adjustment Act of 1975, and
- to make improvements in the administration of the tax laws, particularly to strengthen taxpayers' rights.

The revenue effect of the tax revision and simplification provisions of the committee amendment will be to increase receipts by $1.0 billion in fiscal year 1977 and to reduce receipts by $0.1 billion in fiscal year 1978 and by $0.3 billion by fiscal year 1981. The individual income tax reductions will initially reduce tax liability at an annual rate of $15 billion, but since only the earned income credit and the increases in the standard deduction are made permanent, the longrun revenue loss from the individual tax cuts will be $5.5 billion per year. In fiscal year 1977, the individual tax cuts reduce receipts by $12.5 billion. The business tax reductions—the corporate rate cut for small businesses and the extension of the 10-percent investment credit—in the committee amendment will reduce tax liability by $5.4 billion per year and will reduce tax receipts in fiscal year 1977 by $3.0 billion.

Thus, the overall effect of the amendment will be to reduce receipts by $14.5 billion in fiscal year 1977. This consists of $15.5 billion of tax reductions, offset by almost $1 billion of tax reform. This tax reduction is consistent with the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The feedback, or stimulative, effect of the committee action has been simulated with the Wharton Econometric Forecasting model. It suggests that the committee amendment will increase the gross national product by $5.4 billion in 1976 and by $10.5 billion in 1977. It also is expected to increase by 400,000 the number of jobs available in 1977. Finally, the favorable economic impact of the amendment should itself have a favorable effect on revenues to the extent of $1.4 billion in the fiscal year 1977.

The committee believes that individuals and corporations should bear their fair share of the overall tax burden, consistent with the equally important goals of economic efficiency and growth. The committee amendment makes a variety of changes in the tax law designed to increase tax equity. These are designed not to interfere either with the current economic recovery or with longrun economic growth.

Another important goal is simplification of the tax law and forms. The public should be able to understand the tax system, and the average taxpayer should not have to use a professional tax return preparer. This is particularly true of the tax provisions likely to be used by the average middle or low income individual. The committee amendment simplifies some of the more complicated widely used provisions of the law. In addition,.over 200 pages are devoted to deleting obsolete language in the tax code.

The committee amendment also responds to our extremely serious economic situation. Seven million Americans are now unemployed, and there is a large gap between what the economy is now producing and what it is capable of producing. Under these circumstances, it is essential to continue the economic stimulus provided by the 1975 tax cuts for individuals and businesses. The committee amendment makes permanent about one-half of these tax reductions and extends the other half for one year.

A fourth goal of the committee amendment is to improve the administration of the tax laws to strengthen taxpayers' rights and to make tax collection more efficient. The amendment makes long overdue changes in these areas.

The summary presented below outlines the principal features of the bill under the four general headings referred to above.

Tax revision

1. The committee amendment significantly strengthens the existing minimum tax for individuals, raising the rate from 10 percent to 15 percent, lowering the exemption to no more than $5,000 and adding several new preferences to the base of the tax. These changes will greatly reduce the extent to which income can avoid all tax. (Title I).

2. The committee amendment expands the existing 50-percent maximum tax rate to include a limited amount of investment income. To supplement the strengthened minimum tax as a means of discouraging investment in tax shelters, the amendment provides that income eligible for the maximum tax rate be reduced by all tax preferred income. This is both a matter of fairness to those who do not take advantage of tax shelters and is a way of discouraging the use of tax shelters (Title I).

3. The commitee amendment provides rules to eliminate the abuses of tax shelters. For farm operations, film purchases, equipment leasing, and oil and gas drilling, losses resulting from accelerated deductions are limited to the amount for which the taxpayer is "at risk." To prevent conversion of ordinary income into capital gains, the amendment strengthens the existing recapture rules for real estate and professional sports franchises. There are rules to restrict the use of limited partnerships to syndicate tax shelter benefits and also limits on deductions for prepaid expenses. (Title II).

4. The committee amendment restricts business-related individual income tax deductions in areas where there have been widespread abuses. It limits deductions for expenses attributable to business use of the home, rental of vacation homes and foreign conventions. The

amendment also eliminates virtually all special tax treatment for qualified stock options. (Title III).

5. To promote capital formation, the committee amendment makes several changes in the investment tax credit. These include an additional 2-percent credit if an equivalent amount of stock is put into an employee stock ownership plan. Also, the amendment allows refunds of expiring investment tax credits. The carryover period for net operating losses is extended in place of the carryback period on an optional basis, and the existing rules to prevent "trafficking" in losses are strengthened. Taxes are reduced for the railroad industry through changes in the investment credit and amortization rules. (Title VI.)

6. The committee amendment includes several new tax incentives to promote energy conservation and to increase energy supplies. The most significant of these are tax credits for home insulation expenditures and solar energy equipment. Also, it denies some existing tax incentives in cases where they are not contributing to energy conservation. (Title VII.)

7. There is a tax credit to promote recycling of waste materials. (Title VII.)

8. There are major reforms in the tax treatment of foreign income. Some of the advantages under the existing exclusion for income earned abroad are eliminated; the use of foreign trusts to shelter income from tax is eliminated; the preferential treatment for income from corporations doing business in less developed countries is ended; the per-country limitation on the foreign tax credit is repealed, and a requirement is added providing that foreign losses deducted from U.S. income are to be recaptured in future years; preferential treatment for capital gains in determining the foreign tax credit is ended; the preferences for Western Hemisphere Trade Corporations and China Trade Act Corporations are repealed; and tax incentives for corporations operating in the possessions and Puerto Rico are extensively modified. Existing tax benefits are denied for income earned in connection with foreign bribes or with participation in the Arab boycott of Israel or similar international boycotts. (Title VIII.)

9. The existing tax incentive for exports (DISC) is made applicable only for the increase in exports over a base period. (Title VIII.)

10. Interest earned in the U.S. is exempted from income tax in the case of nonresident aliens and foreign corporations. (Title VIII.)

11. Private foundations are to be required to pay out their earnings or 5 percent (instead of 6 percent or better) of their assets and are to pay an audit-fee tax of 2 percent of income (instead of 4 percent). (Title X.)

12. The provision for individual retirement accounts (IRA) is modified to allow one spouse to set up such an account for a nonworking spouse. Other modifications are also made in the pension provisions. (Title XI.)

13. Casualty insurance companies with losses are, subject to limitations, permitted to file consolidated returns with life insurance companies. (Title XI).

14. The expired provision for five-year amortization for pollution control facilities is re-enacted, and these facilities also are given the investment tax credit at two-thirds the usual rate. (Title XIII).

15. The committee amendment also makes several miscellaneous changes in the tax law, dealing with tax treatment of condominiums, real estate investment trusts, disaster loans, publishers, face-amount certificates, student loan forgiveness, subchapter S corporations, the work incentive (WIN) tax credit, corrections of the 1975 provisions on percentage depletion for oil and gas, and other areas. (Title XIII).

Tax simplification

1. The committee amendment revises the existing optional tax tables by basing them on taxable income instead of adjusted gross income and increasing to $20,000 the maximum amount of taxable income a taxpayer can have and still use the tables. (Title IV).

2. The deduction for alimony is made available to taxpayers who claim the standard deduction. (Title IV).

3. The retirement income credit is significantly simplified and is made more equitable by converting it into a "tax credit for the elderly." The amount of income on which the credit is computed is increased, and earned income is made eligible for the credit. To reduce the revenue loss from these liberalizations and focus the relief where it is most needed, the credit is phased out for taxpayers with high incomes and is eliminated for public employees under age 65. (Title IV).

4. The child care deduction is converted to a 20-percent tax credit. The eligibility for the credit is to be broader than for the existing deduction, and the provision is greatly simplified. (Title IV).

5. The complex sick pay exclusion is eliminated, except for the permanently and totally disabled. The exclusion of disability pay from income is ended for future members of the Armed Forces. Veterans' Administration benefits, however, remain tax exempt. (Title IV).

6. The deduction for moving expenses is simplified and liberalized. (Title IV).

7. The difficult rules dealing with accumulation trusts are considerably simplified. (Title IV).

8. The committee amendment limits the deduction for State and local gasoline taxes to those above a $50 floor. (Title IV).

9. The committee amendment also contains the "deadwood bill" that repeals and revises many obsolete and rarely used provisions of the Internal Revenue Code. (Title XII).

Extension of tax reductions

1. The committee amendment makes permanent the increases in the standard deduction in the Revenue Adjustment Act of 1975. It increases the minimum standard deduction from $1,300 to $1,700 for single returns and to $2,100 for joint returns. It raises the percentage standard deduction from 15 percent to 16 percent. Also, it raises the maximum standard deduction from $2,000 to $2,400 for single returns and to $2,800 for joint returns. These changes involve a decrease in budget receipts in fiscal year 1977 of $4.1 billion. (Title V).

2. The refundable earned income credit of 10 percent of the initial $4,000 of earnings, phased out as income raises from $4,000 to $8,000, is made permanent. This involves a reduction in receipts in fiscal year 1977 of $0.7 billion. (Title V).

3. The general individual income tax credit (enacted for the first half of 1976 in the Revenue Adjustment Act of 1975) is extended for

12 additional months until June 30, 1977. This credit equals the greater of $35 per taxpayer and dependent or 2 percent of the first $9,000 of taxable income. The reduction in receipts in fiscal year 1977 is $7.6 billion. (Title V).

4. The tax reductions for small business are made permanent. These increase the corporate surtax exemption from $25,000 to $50,000 and reduce the tax rate on the first $25,000 of taxable income from 22 percent to 20 percent. The reduction in receipts in fiscal year 1977 is $1.7 billion. (Title V).

5. The increase in the investment credit to 10 percent is made permanent. The decline in receipts in fiscal year 1977 is $1.3 billion per year. (Title VI).

Administrative provisions

1. The amendment contains rules for disclosure of private letter rulings. (Title IX).

2. It provides definitive rules generally maintaining the confidentiality of tax returns. (Title IX).

3. There are provisions for better regulation of tax return preparers. (Title IX).

4. Restrictions are placed on jeopardy and termination assessments and use of the administrative summons by the Internal Revenue Service. (Title IX).

5. The committee amendment makes several changes in the withholding system. (Title IX).

6. The committee amendment provides for declaratory judgments in determining the tax-exempt status of charitable organizations. (Title X).

II. REASONS FOR THE BILL

The Tax Reform Bill of 1976, as amended by the Finance Committee, is designed to serve four major purposes. First, it is intended to improve the equity of the tax system at all income levels without impairing economic efficiency and growth. Second, the committee amendment effects important simplifications of the tax system by redrafting complex but widely used provisions, deleting obsolete language, and encouraging taxpayers to switch to the standard deduction. Third, the amendment extends for one additional year the fiscal stimulus provided by the Tax Reduction Act of 1975 and extended by the Revenue Adjustment Act of 1975 and makes permanent about half of these tax cuts. Fourth, the committee amendment improves the administration of the tax laws, making it more efficient and strengthening taxpayers' rights.

Tax Revision

While no one contends that our income tax system does not need improving, it is still widely acknowledged to be the best in the world. The difficulty faced in improving the system is that the American people want different things from their tax system. On the one hand, they want every individual and corporation to pay a fair share of the overall income tax burden. In a system that depends heavily on voluntary compliance with the tax laws, as ours does, tax equity is especially important. However, at the same time, Americans do not want the income tax system to interfere with economic efficiency and growth. This implies that tax changes to promote equity should not retard either the current recovery from what has been the worst recession since the 1930's or impede longrun growth in the economy. The tax revisions in the committee amendment represent a careful balance between these sometimes conflicting objectives.

The committee amendment contains many tax revisions, described in more detail below, designed to eliminate tax abuses. This action is necessary to keep people from losing confidence in the equity of our tax system. It is essential that these abuses be eliminated, as is done in the committee amendment.

The committee believes that many so-called "tax expenditures" do not represent tax abuses but rather are legitimate incentives which are desirable to accomplish widely held social goals. In many cases, there seems to be wide agreement that tax expenditures should be retained. These incentives, at least to some degree, are needed to improve the performance of the economy, a goal that is especially significant at this time of high unemployment; and repealing many of these tax incentives would be counter-productive. Nevertheless, the committee amendment significantly limits many of the incentive provisions which it does not completely eliminate.

Minimum and maximum tax

The committee believes that high-income people should not be able to escape liability for the individual income tax. Preventing this is a major feature of the committee amendment. The amendment will greatly reduce the incidence of tax avoidance by high-income people through two related provisions—a stiffer minimum tax on tax-preferred income and a maximum tax designed to discourage use of tax preferences.

The existing minimum tax for individuals is inadequate. In 1974 it raised only $130 million, down from $182 million in 1973, which is only a small fraction of total tax-preferred income. Also, the current minimum tax for individuals is largely a tax on one preference—the excluded half of capital gains, which is seven-eighths of the preferences subject to the minimum tax. The committee amendment amends the minimum tax both to increase its revenue yield and to broaden considerably the tax preferences covered under the minimum tax.

The committee amendment raises the minimum tax rate from 10 percent to 15 percent. In place of the existing $30,000 exemption and deduction for regular income taxes, the amendment has an exemption equal to regular income taxes or $5,000, whichever is greater. To discourage use of tax shelters, new minimum tax preferences are added for construction period interest on real estate, accelerated depreciation on all personal property subject to a lease, and accelerated intangible drilling costs in excess of oil-related income. Excess investment interest is added as a preference in place of the ineffective existing limit on the deduction of such interest. Finally, to impose some tax in cases where there is excessive use of itemized personal deductions, there is a new preference for itemized deductions (other than medical expenses and casualty losses) in excess of 60 percent of adjusted gross income. There is a transitional rule to limit the impact of these changes on subsidized housing.

While the minimum tax is designed to deal with taxpayers who pay less than their fair share of tax, the committee felt that there should also be some tax relief, in the form of expansion of the maximum tax, for those who pay more than their fair share. Because of its structure, this maximum tax also represents a positive inducement to direct productive enterprise, rather than devoting time to seeking out economically inefficient tax shelters.

In 1969, Congress enacted a 50-percent maximum marginal tax rate on income from personal services. To reduce the incentive to invest in tax shelters, the law provides that income eligible for this maximum rate be reduced by tax preferences (as defined under the minimum tax) in excess of $30,000. The committee believes that this 50-percent maximum rate should be extended to a limited amount of investment income; therefore, the amendment makes eligible for the 50-percent rate an amount of investment income equal to the taxpayer's personal service income (in excess of preferences) or $100,000, whichever is less.

The existing "preference offset" in the maximum tax has not been as effective in discouraging investment in tax shelters as originally planned. The committee amendment should greatly increase its effectiveness in this respect. First, extending the maximum tax to a limited amount of investment income will mean that many taxpayers will have no income at all taxed at rates higher than 50 percent, commonly viewed as the rate bracket at which it is profitable.to begin utilizing tax shelters. Second, the expanded list of tax preferences will make the preference offset much more effective. Finally, the amendment repeals the existing $30,000 floor on preferences that must reduce earned income.

The committee believes that these minimum and maximum tax changes, together with other tax changes described below, will eliminate the abuses associated with tax shelters to the extent appropriate in view of their economic impact. The committee's approach is superior to that adopted in the House bill—the limitation on artificial losses (LAL). The committee rejected the LAL approach both because of its extreme complexity and because it would have had a serious adverse impact on the economy.

Other tax shelter provisions

The committee believes that while the changes in the minimum and maximum taxes deal with much of the problem, other changes are also needed to end tax shelter abuses. Some investments are motivated bv excessive concern with the tax benefits associated with them, not their economic merits. In some cases the manner in which the tax shelters are contrived is questionable even under present law. In others, individuals are combining provisions of the law, or leveraging them through nonrecourse borrowings, in a way clearly not intended by Congress. The committee amendment contains a number of provisions designed to curb these abuses without interfering with economically worthwhile investments.

Some of these tax shelter provisions are dealt with by strengthening the rules to prevent conversion of ordinary income into capital gains. Thus, in the case of real estate and sports franchises, the present recapture rules are tightened or new ones added. For oil and gas drilling, farm operations, equipment leasing, and film purchases, losses from accelerated deductions are limited to the amount for which the individual is "at risk." This is designed to prevent leveraging of tax shelter benefits through the use of nonrecourse loans. In addition, in the case of farm syndicates and motion picture production companies, certain costs are required to be capitalized and written off over the productive period of the related assets. The provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be al'ocated among the various partners according to whomever can maximize the tax benefits unless such allocation also has substantial economic effect. Also, limits are nlaced on the amount of "bonus" first-year depreciation deductions of the partners. Finallv, the amendment includes limits on nrepaid expense deductions by farm syndicates and on prepaid interest deductions.

Business expenses under the individual income tax

Many individuals are now claiming deductions for the business use of their home or for expenses related to the rental of their vacation homes for a brief part of the year. While in theory there is nothing wrong with appropriate deductions for business or investment expenses, in practice it is often extremely difficult to allocate between

deductible business expenses and nondeductible personal expenses. The result is that many people are deducting as business deductions amounts which really represent personal expenses. To deal with this
Another area where there is a tax abuse is claiming deductions for
problem, the bill places strict limits on these deductions.
foreign conventions in cases where the main purpose of the trip is clearly pleasure. The committee amendment eliminates these deductions unless there are valid reasons for holding the convention outside of North America (including the Caribbean).

The committee amendment repeals, with an exception for small businesses, the special tax treatment for qualified stock options. With personal service income subject to a maximum rate of 50 percent, there is not reason for not taxing as ordinary income these forms of compensation.

The amendment also makes provision for the deduction of a limited amount of business expenses of State legislators while at their State capitals on official business.

Capital formation

The committee is convinced that the U.S. economy is faced with a severe shortage of capital. In 1973 and early 1974, there were capacity shortages in many major industries because investment in them had been inadequate in the previous five years. The growth rate of labor productivity has slowed, again because of inadequate investment. We have had the most success in stimulating investment in recent years by the use of the investment tax credit. There appears to be a close correlation since 1962 between the presence of the investment credit and purchases of equipment. As a result, the committee amendment makes the investment credit permanent at a 10-percent rate. Studies by the committee estimate that for each dollar of revenue loss from the investment credit, the propensity to invest increases by $1.30. This stimulates the economy and provides partly offsetting increases in Federal revenues.

The committee amendment modifies the investment tax credit to provide for an additional two percentage points of credit if the taxpayer puts an equivalent amount of stock into an employee stock ownership plan. This extends and expands a similar provision (which is currently at a one-percent rate) enacted in 1975, but technical amendments added (as well as the two-percent rate) should significantly increase the extent to which the provision is used by business. This option is desirable to broaden employees' ownership in business and thereby increase their interest in improving productivity. This option will also serve the twin goals of increasing capital accumulation and creating a more equal distribution of wealth.

To make the credit available to less profitable businesses, the committee has made it refundable at the end of the 7-year carryover period. In addition, carryovers of investment credits (as well as foreign tax credits) which otherwise would expire in 1976 without being used, because of limited or no profits in prior years, are extended for two more years.

Another provision to promote capital accumulation, which will be especially important for new business, is one that gives businesses an option to elect an 8-year net operating loss carryforward instead of the existing 3-year carryback and 5-year carryforward. By allowing more flexibility in averaging profits and losses, this will encourage risktaking. It will also encourage investment in new businesses, which cannot use a loss carryback. The amendment tightens the existing rules to prevent "trafficking" in losses, in order to reduce any tax incentives towards business mergers. In addition, the capital loss carryover period for mutual funds is extended from 5 years to 8 years.

For railroads, an industry in need of modernization which has trouble generating internal funds, the committee amendment provides a tax reduction through changes in the investment credit and in amortization rules. For similar reasons, an investment credit is made available to the domestic merchant marine for funds withdrawn from their tax-deferred ship construction fund to purchase ships.

Finally, the committee amendment, in order to encourage domestic production, makes the investment credit available in the future for motion picture productions only where they are predominantly American-produced films. For the past, a compromise between the Internal Revenue Service and the industry is worked out as to the appropriate investment credit intended under the relatively uncertain provisions of prior law.

Energy incentives

Despite the Arab oil embargo of 1973–74, Congress has taken no significant action to reduce our dependence on foreign oil. We are as vulnerable now to an embargo as we were in 1973. In response to this serious problem, the committee has added several new tax incentives designed to reduce energy demand and increase supply.

To encourage use of insulation of existing buildings, the amendment provides a refundable credit for home insulation and makes business insulation eligible for the investment tax credit. It provides tax incentives for solar and geothermal energy, making geothermal energy eligible for percentage depletion and deduction of intangible drilling costs and providing tax credits for installation of solar and geothermal energy equipment. There is also a tax credit for heat pumps.

The amendment provides additional investment credits (at 12 percent) for investment in equipment needed to aid in developing alternative energy sources, including deep-mining coal equipment, coal-slurry pipelines, waste-burning equipment, equipment to convert organic material to fuels, geothermal energy, oil shale equipment and coal liquefaction and gasification equipment. Investment in these alternative sources is essential if we are to reduce our dependence on foreign oil.

Other energy-related provisions include changes to eliminate the existing tax discrimination against use of rerefined lubricating oil and instead to create a tax bias in its favor and a denial of the investment credit for space heaters and air conditioners.

The amendment also contains a tax credit for use of recycled waste materials.

Tax treatment of foreign income

The committee amendment makes several important changes in the tax treatment of foreign income. It is necessary to strike a delicate balance between encouraging the free flow of capital across national borders and making sure that the tax laws do not provide excessive incentives for foreign investment instead of investment at home. The committee decided to retain the basic structure of the taxation of foreign income—a foreign tax credit for income earned abroad and taxation of income of foreign subsidiaries (except in the case of "tax haven" income) when returned to this country. However, it eliminates virtually all other incentives for investment abroad.

An important change is the repeal of the per-country limitation on the foreign tax credit. The per-country limit enables a firm with a loss in one country and a profit in another to deduct the loss against U.S. income and still avoid U.S. tax on the profit through the foreign tax credit. Its repeal will eliminate this problem and will also greatly simplify this part of the tax law. The committee amendment also provides for recapture of foreign losses deducted from U.S. income when foreign profits are earned in subsequent years.

The committee amendment repeals numerous tax incentives which favor investment in some foreign areas over others—those which favor investment in less-developed country corporations, China Trade Act corporations and Western Hemisphere trade corporations. It also substantially revises and improves the tax provisions relating to U.S. possessions. Except in the case of U.S. possessions, the committee felt that there was no longer any good reason for favoring foreign investment in one of these foreign areas over another.

The committee amendment, while retaining the existing exclusion for income earned abroad, has eliminated special features of this provision enabling those with income above the basic exemption levels to obtain additional benefits from the exclusion.

A major area of controversy is the DISC provision that permits deferral of tax for one-half of export income. To make this incentive more efficient, the committee agreed to limit most DISC treatment to the excess of a firm's exports above a moving base period level. Thus, DISC tax deferral will generally only be available to firms who continue to increase their exports.

The committee does not believe that multinational corporations should benefit from tax incentives when they engage in misconduct. Thus, the amendment denies the foreign tax credit, tax deferral, DISC treatment and the exclusion for income earned abroad for income earned in connection with participation in international boycotts, such as the Arab boycott of Israel. Except for the exclusion for income earned abroad, these incentives are also denied for income earned in connection with foreign bribes.

The committee amendment makes permanent the existing exemption for interest from the 30-percent withholding tax (or lower tax where treaties are in effect) on nonresident aliens and foreign corporations from bank accounts in the U.S. (scheduled to expire at the end of this year), and extends this treatment to all portfolio interest income. This change will help attract foreign capital into the U.S. but without providing incentives for investments in equities.

The committee amendment also corrects several technical errors resulting from the changes in the taxation of foreign income made by the Tax Reduction Act of 1975.

Other tax revisions

The committee amendment makes a large number of other relatively minor revisions in the tax law. Many of these deal with inequities that have come to the attention of the committee.

The committee amendment includes a number of provisions relating to pensions. Probably the most important of these is one which expands the existing provision for individual retirement accounts (IRAs) to permit a working spouse to set up an IRA for a nonworking spouse. This change recognizes the contributions to the family made by nonworking spouses and their need for income during old age. If an IRA is set up for both spouses, a $2,000 contribution limit could apply. Contributions could be made, subject to that limit, to a joint IRA or two separate IRAs. If an IRA is not set up for the spouse who isn't employed outside the home, the present $1,500 contribution limit would continue to apply. Another pension provision permits an amount of up to $750 to be set aside each year in an H.R. 10-type plan where income is $15,000 or under without the amount being limited to 25 percent of an individual's income.

There are several amendments relating to tax-exempt organizations. Among these is one which reduces the excise tax on investment income of private foundations from 4 percent to 2 percent because the latter figure better reflects the IRS's administrative costs of regulating private foundations. Another amendment sets the payout requirement (if larger than actual earnings) for foundations at 5 percent (instead of 6 percent) of asset value and provides that this limit is not to be varied as interest rates generally change. A third sets up a court review procedure where the IRS holds that an organization does not qualify for exempt status.

There also are a number of changes relating to the taxation of insurance companies. Among these is one which permits casualty insurance companies to file consolidated returns with life insurance companies but in a manner which does not permit the losses of the casualty companies to remove more than half of the life insurance income from taxation. Another amendment continues for two more years the present treatment of salary reduction plans and similar plans.

There are technical changes in the tax treatment of real estate investment trusts, housing cooperatives and condominiums, authors and publishers, creditors of political parties, subchapter S corporations, the work incentive (WIN) tax credit, face-amount certificates, personal holding companies, oil and gas producers, losses from disasters, and deductions for removing architectural and transportation barriers for handicapped people.

Several tax provisions that have recently expired are extended in the committee amendment. These include rapid amortization provisions for pollution control facilities and rehabilitated low-income housing. Pollution control facilities are also given two-thirds of the normal investment credit, which differs from the prior provision under which 5-year amortization was an alternative to the investment credit. The committee believes that since Federal regulations require installation of pollution control equipment, it is equitable to reduce the cost of capital for such equipment. Also, the exclusion from income for certain forgiven student loans is extended through 1978.

Tax Simplification

Tax simplification is the second major goal of the committee amendment. Simplification must be an ongoing process, and the individual provisions of the tax law must be reexamined periodically to see how they contribute to the complexity of the law. Unless this reexamination occurs, the law will grow gradually more complicated as new provisions are added to achieve new goals of society. This amendment repeals or restructures some of the more complicated provisions of the law.

One such provision concerns the use of the tax tables. The amendment eliminates the existing tax tables based on adjusted gross income, which have been a major source of taxpayer error, and substitutes a simpler set of tables based on taxable income. It also raises to $20,000 the taxable income level where these tax tables may be used. From the standpoint of the average taxpayer this may well represent the most significant simplication made.

A second simplification concerns the retirement income credit. This was originally designed to give those who retire without social security tax exemptions similar to that accorded social security benefits. As a result, eligibility for the credit and its computation were designed to follow as closely as possible eligibility for, and computation of, social security benefits. This has required a complex form that requires a whole page, and it is estimated that a large fraction of the people eligible for the credit either do not claim it or make errors in computing it. In response to this problem, the committee has restructured the credit to eliminate virtually all the complexity, even though this means breaking the close link between the retirement income credit and social security eligibility. This new credit for the elderly will be fairer than the retirement income credit in existing law since it will also be applicable to earned income for taxpayers age 65 or over. Also, the amendment repeals the credit for retired public employees below age 65, since this group should not have special tax treatment not available to other retired persons.

Another complicated provision is the sick pay exclusion. In this case, the committee has concluded that the exclusion should be allowed only for persons who are permanently and totally disabled, since for other people there is no reason why sick pay should be treated more favorably than wage income, particularly in view of the deductibility of medical and drug expenses. For those still eligible for the sick pay exclusion, the provision has been considerably simplified and coordinated with the new credit for the elderly.

The committee amendment makes major changes in the treatment of child and dependent care expenses. Currently, these are allowed as an itemized deduction, subject to some complicated limitations. The amendment converts the deduction into a 20-percent credit, so that it will be available to those who use the standard deduction as well as to itemizers and so that it will provide the same tax relief to taxpayers in low brackets as to those in high brackets. The child care deduction in existing law is worth 70 cents for each dollar of child care expenses for a taxpayer in the 70-percent bracket, but only 14 cents to a low-bracket taxpayer who itemizes deductions and nothing to someone who uses the standard deduction. The new credit will be worth 20 cents for each dollar of child care expenses for all taxpayers. In addition, the amendment significantly simplifies the child care provision and broadens eligibility for it.

The committee amendment makes several other changes that will simplify the law or make it more equitable, including a revision of the rules relating to accumulation trusts and the moving expense deduction. The alimony deduction is moved from an itemized deduction to a deduction in determining adjusted gross income, so that it can be used by people who take the standard deduction.

One of the most difficult, widely-used deductions is the one for State and local gasoline taxes. Few taxpayers compute this deduction accurately, and permitting such a deduction is also contrary to the nation's energy policy. Thus, the committee has decided to limit this deduction to taxes above a $50 floor, so that many taxpayers will not have to take the trouble of computing it. The deduction will still be available, above the $50 floor, to those who use large amounts of gasoline.

There are some cases where it is possible to achieve some tax simplification without changing the substance of the law. The amendment includes the so-called "deadwood bill" which deletes obsolete and rarely used provisions from the Internal Revenue Code and makes many other changes to shorten and simplify the Code.

These provisions are only the beginning of what must be a continual process of tax simplification. The committee plans further simplification measures and has instructed the staff of the Joint Committee on Taxation to conduct a comprehensive study of ways to simplify the income tax system. Also, the amendment instructs the Secretary of the Treasury to furnish to Congress the results of Treasury studies on tax simplification.

Extension of Tax Reductions

Economic conditions

A third major purpose of the committee amendment to H.R. 10612 is to extend the fiscal stimulus provided by the Tax Reduction Act of 1975 and subsequently extended for the first half of 1976. The Tax Reduction Act provided a tax cut, a tax rebate and increased expenditures totaling $23 billion for 1975.[1]

The 1975 tax cut included a temporary increase in the standard deduction and a $30 nonrefundable tax credit for each taxpayer and dependent, which reduced tax liability by $8 billion and was reflected in lower withheld and estimated tax payments over the last 8 months of 1975. There was also an earned income credit involving $1.4 billion and a home purchase credit amounting to about $0.6 billion. Finally, there were business tax reductions—an increase in the investment tax credit and a corporate rate cut for small businesses—amounting to $5 billion.

The 1975 increase in the standard deduction and the $30 credit, which reduced tax liability by $8 billion, were reflected in lower withheld and estimated tax payments over the last 8 months of 1975 at the rate of $1 billion per month, or $12 billion per year. In the Revenue Adjustment Act of 1975, Congress decided to extend these same withholding rates for the first half of 1976 and to provide a cut in tax lia-

[1] This included a rebate on 1974 individual income taxes of $8.4 billion and a $50 one-time payment to social security recipients and increased unemployment compensation amounting to $2 billion.

bility for 1976 approximately equal to this $6 billion reduction in withholding. Also, that Act extended the small business tax cuts and the earned income credit for the first half of 1976. (The increase in the investment credit had been put into effect for 1975 and 1976 in the Tax Reduction Act.)

The committee has analyzed economic conditions and believes it is inappropriate to withdraw the economic stimulus provided by the tax reductions. Due in no small part to the tax reductions, there has been an adequate rate of recovery from the 1974–75 recession in the past 12 months. Output has grown at a rate of 7 percent, and we have regained the level of income and production that existed at the end of 1973, prior to the recession. Since then, however, the capacity of the economy has grown and will continue to grow, and the economic forecasts examined by the committee indicate that there is likely to be excess capacity in the economy for at least the next year. While the unemployment rate has fallen from 9 percent to 7.3 percent, the existing unemployment rate is still unacceptably high. For these reasons, the committee has agreed to extend the existing tax cuts for at least another 12 months and to make about one-half of the tax cuts permanent.

The committee does not believe that a permanent extension of the entire $20 billion in tax reductions now in effect is appropriate at this time. There is uncertainty about just how much excess capacity now exists in the economy, how serious will be the inflation problem in the years ahead and what budgetary requirements will be for the rest of the decade.

The committee asked eight prominent economists, drawn equally from both major political parties, whether they favored an extension of the existing $20 billion in tax cuts and, if so, for how long. Seven of them were former members of the Council of Economic Advisers. All of the economists favored extension of the tax cuts at least for the rest of this year, but only four of them thought the cuts should be made permanent.

In view of the uncertain economic and budgetary situation, the committee has agreed to make one-half of the $20 billion tax reduction permanent and to extend the other half only for one year—until June 30, 1977. This will afford the Congress and Administration next year an opportunity to review economic conditions and the fiscal requirements to see what, if any, further extensions of these tax cuts should be made.

Individual tax reductions

The committee amendment makes permanent $5.5 billion of individual tax reductions. These are the increases in the standard deduction and the earned income credit. The amendment extends for one year the general tax credit adopted in the Revenue Adjustment Act, which involves a tax cut of $9.7 billion.

The committee amendment permanently increases the minimum standard deduction (or low-income allowance) from $1,300 to $1,700 for single returns and to $2,100 for joint returns. It increases the percentage standard deduction from 15 percent to 16 percent. Also, it increases the maximum standard deduction from $2,000 to $2,400 for single returns and to $2,800 for joint returns. This will reduce tax liability at a rate of $4.1 billion and will lower budget receipts in fiscal year 1977 by $4.1 billion. This increase in the standard deduction represents a major simplification of the individual income tax, since it will make it worthwhile for filers of 9 million tax returns to switch to the standard deduction. Also, this change creates greater tax equity, since itemized deductions have been free to rise with inflation, while the minimum and maximum standard deductions stay constant unless there is specific legislative action.

There is also a permanent extension of the earned income credit. This is a refundable credit, available only to people with dependent children, equal to 10 percent of the first $4,000 of earnings, phased out as income rises between $4,000 and $8,000. It involves a cut in tax liability at a rate of $1.3 billion, and a reduction in fiscal year 1977 budget receipts of $0.7 billion. The earned income credit provides a strong work incentive for those who are limited to jobs that pay low wages. It provides desperately needed tax relief to a hard-pressed group, who are faced with high food and energy prices and are subject to the payroll tax.

The committee amendment extends for one year the general tax credit adopted in the Revenue Adjustment Act, which reduces tax liability at a rate of $9.7 billion. The one-year extension will reduce fiscal year 1977 receipts by $7.6 billion. This credit equals the greater of $35 for each taxpayer and dependent or 2 percent of the first $9,000 of taxable income.

Together, the individual tax cuts amount to a cut in tax liability at an annual rate of $15 billion. They will reduce budget receipts in fiscal year 1977 by $12.5 billion.

Business tax reductions

In order to provide sufficient economic stimulus and to encourage businesses to invest, the committee amendment makes permanent the business tax cuts from the Tax Reduction Act of 1975. These reduce tax liability at a rate of $5.4 billion and will reduce tax receipts in fiscal year 1977 by $3.0 billion.

The committee amendment makes permanent the current 10-percent investment (applicable now through 1976). This represents an increase from the previous 7-percent rate for most businesses and from the 4-percent rate for public utilities. Also, the amendment permanently increases the limit on used property eligible for the credit from $50,000 to $100,000. These changes will reduce tax liability by $3.3 billion in 1977 and will lower budget receipts by $1.3 billion in fiscal year 1977.

The investment credit has proven an effective way to stimulate investment in equipment. Its enactment in 1962 and its reenactment in 1971 were followed by investment booms, and its suspension in 1966 and repeal in 1969 were followed by sharp declines in investment. According to the equations in the Chase Econometric model, an increase in the rate of the investment credit costing $1.00 will increase the propensity of businesses to invest by about $1.30, an impact that builds up over a three-year period. We need to increase investment in the U.S. economy to improve our standard of living and to achieve energy, environmental and other goals; and under these circumstances, the committee believes a permanent extension of the 10-percent investment credit is appropriate. The credit for utilities is increased to the same rate as that for other businesses because the committee believes they should be able to compete for capital on the same basis as other industries.

The committee amendment also makes permanent the small business tax cuts enacted in 1975. These increase the corporate surtax exemption from $25,000 to $50,000 and reduce the tax rate in the initial $25,000 of corporate income from 22 percent to 20 percent. The reduction in tax liability is $2.1 billion in 1977, and the reduction in budget receipts is $1.7 billion in fiscal year 1977. This change will improve the competitive position of small business.

Economic effects of tax cut extension

The extension of these tax reductions should cause a significant increase in output and employment. Table 1 shows forecasts of the economy, using the Chase Econometric model, under the assumption that the tax cuts are extended and that they are allowed to expire. It shows that the tax cuts can be expected to increase gross national product by $23 billion by the end of 1977. This would be more than a one-percent increase in real output. Investment in plant and equipment is expected to be higher by 2 percent because of the tax cut. The unemployment rate is expected to be lower by 0.4 percent, or by 400,000 workers.

The Wharton Econometric Forecasting model suggests an increase in gross national product of as much as $16 billion through 1977 and also an increase of 400,000 in jobs in 1977. This model further suggests that the stimulative effect of the committee amendment will be to increase receipts in 1977 by $1.4 billion.

TABLE 1.—ECONOMIC EFFECTS OF TAX CUT EXTENSION[1]

[Dollar amounts in billions]

	Year and quarter							
	1976				1977			
	I[2]	II	III	IV	I	II	III	IV
GNP (current prices):								
With tax cut	$1,619	$1,662	$1,709	$1,765	$1,815	$1,869	$1,914	$1,959
Without tax cut	1,619	1,662	1,707	1,758	1,804	1,853	1,894	1,936
Difference	0	0	+2	+7	+11	+16	+20	+23
GNP (1972 prices):								
With tax cut	1,241	1,258	1,276	1,295	1,313	1,330	1,338	1,342
Without tax cut	1,241	1,258	1,275	1,290	1,305	1,319	1,325	1,328
Percent difference	0	0	0	+.4	+.6	+.8	+1.0	+1.1
Unemployment rate (percent):								
With tax cut	7.5	7.3	7.1	6.8	6.6	6.6	6.8	7.2
Without tax cut	7.5	7.3	7.1	6.9	6.8	6.8	7.0	7.6
Difference	0	0	0	−.1	−.1	−.2	−.3	−.4
Investment in plant and equipment (1972 prices):								
With tax cut	77	82	85	90	94	96	98	98
Without tax cut	77	82	85	90	94	95	96	96
Difference	0	0	0	0	0	+1	+2	+2

[1] Forecasts with Chase econometric model. Tax cuts include individual tax cuts, corporate rate cut for small business, and 10-percent investment credit.

[2] Actual figures.

Administrative Provisions

A fourth major goal of the committee amendment is to improve the administration of the tax laws. The amendment contains several provisions to improve efficiency of administration through changes in withholding taxes and better regulation of tax return preparers. The most significant administrative provisions are those which strengthen taxpayers' rights.

The committee amendment provides definitive rules relating to the confidentiality of tax returns, an area where there has been much abuse in the past. It strictly limits disclosure of information from tax returns. The ability of the Internal Revenue Service to use jeopardy and termination assessments and to issue so-called "John Doe" summons also is limited.

At the same time, rules are provided for the publication of private letter rulings so everyone will have an equal opportunity to know the view of the IRS on the proper interpretation of the tax law. New rules are also added to aid the Service in reviewing the way in which tax return preparers carry out their duties.

In the case of withholding tax provisions, a number of changes are made: provision is made to withhold at the rate of 20 percent on income from most wagering where the amount won is $1,000 or over; in the case of fishing vessels where the catch is shared, the sternmen are treated as independent contractors; and provision is made for the withholding of State and local income taxes on a mandatory basis.

III. REVENUE EFFECTS

As indicated in Table 1, the tax reform provisions of the committee amendment to H.R. 10612 are estimated to result in an increase of almost $1 billion in fiscal year 1977, and small decreases ranging between $80 million and $263 million in the fiscal years 1978 through 1981. Extension of the income tax cuts made by the Revenue Adjustment Act of 1975 is estimated to result in a decrease in receipts of $15.5 billion in fiscal year 1977, $11.5 billion in fiscal year 1978, $11.6 billion in fiscal year 1979, and somewhat greater amounts thereafter. In the fiscal year 1977, most of the tax reduction is accounted for by the individual income tax reduction since the 10-percent investment credit rate is effective through the end of 1976 under present law. The combined effect on tax receipts of the tax reform and tax reduction provisions in the committee amendment is a decrease of $14.5 billion in fiscal year 1977, of $11.6 billion in fiscal year 1978, of $11.8 billion in 1979, of $12.3 billion in 1980 and of $13 billion in 1981.

The Wharton economic forecasting model suggests that, because of the stimulative effect of the amendment, additional receipts of $1.4 billion will be generated in fiscal year 1977 resulting in a net reduction of receipts in that year of $13.1 billion rather than $14.5 billion.

Table 2 shows the changes in calendar year tax liability under the committee amendment. The individual income tax reductions total $7.5 billion for calendar year 1976, $10.5 billion for 1977, $5.6 billion for 1978, $5.8 billion for 1979, $6 billion for 1980, and $6.2 billion for 1981. Permanent extension of the 10-percent investment tax credit and the change in corporate tax rates are estimated to result in decreased tax liability for business of almost $1 billion for 1976, $5.4 billion for 1977, $5.7 billion for 1978, $6.1 billion for 1979, $6.4 billion for 1980, and $6.9 billion for 1981. The combined effect on tax liability of the tax reform and tax reduction provisions in the committee amendment is a decrease of $7.3 billion in calendar year 1976, of $15.7 billion in 1977, of $11.4 billion in 1978, of $12 billion in 1979, of $12.5 billion in 1980 and $13.3 billion in 1981.

Table 3 shows the impact on tax receipts of each of the tax reform provisions in the transition quarter and in each of the fiscal years 1977 through 1981. As indicated in this table, the chief contributors to revenue raising tax reform are the minimum tax provision, representing close to $1 billion for 1977; the sick pay provision, about $350 million; the $50 floor under the gas tax deduction, nearly $300 million; and the business use of homes and rental of vacation homes provisions, about $200 million. The principal categories of revenue reducing tax reform are the child care provisions, almost $350 million for 1977; the ESOP provisions, $235 million; the home insulation tax credit provision, almost $200 million; and the retirement income credit provision $101 million. Table 3 also breaks down the net effect of the tax reform provisions between individuals and corporations.

Table 4 presents in terms of calendar year liability the data set forth in Table 3 on a fiscal year receipts basis.

Tables 5, 6, and 7 show, by adjusted gross income class, for calendar years 1976, 1977, and 1978, respectively, the decrease in individual income tax liability resulting from the permanent extension of the standard deduction and earned income credit provisions and the extension through June 30, 1977, of the per capita tax credit provision.

Table 5, which reflects the effect of a six-month extension in 1976 (July 1-December 31) of the three individual income tax cut provisions of the committee amendment, shows that almost 40 percent of the $7.2 billion reduction goes to returns with less than $10,000 of adjusted gross income, 24 percent goes to returns with between $10,000 and $15,000 of adjusted gross income, and almost 18.5 percent to returns with adjusted gross income between $15,000 and $20.000 of adjusted gross income. This table also indicates that 71.9 million returns show a decrease in tax liability, of which 3.2 million become nontaxable returns. Also, as indicated in this table, 4.5 million returns are estimated to shift to the standard deduction.

Table 6, which reflects the effect in 1977 of a full extension of the standard deduction and earned income credit provisions and a half-year extension of the per capita tax credit (through June 30, 1977), shows that over 48 percent of the $9.7 billion reduction goes to returns with less than $10,000 of adjusted gross income, almost 20 percent to returns with between $10,000 and $15,000, and 17 percent to returns with between $15,000 and $20,000. Almost 74 million returns show a decrease in tax liability, of which 5.4 million become nontaxable and 9.3 million shift to the standard deduction.

Table 7, which reflects the effect in 1978 of a full year extension of the standard deduction and earned income credit provisions of the committee amendment, shows that over 68 percent of the $5.2 billion reduction goes to returns with less than $10,000 of adjusted gross income, almost 10.5 percent goes to returns with between $10,000 and $15,000, and almost 13 percent to returns with between $15,000 and $20,000. Close to 51 million returns show a decrease in tax liability, of which 4.2 million become nontaxable and 9.3 million shift to the standard deduction.

Tables 8, 9, and 10 show for selected tax returns, representing different marital status, different numbers of exemptions, and different levels of adjusted gross income, the tax burden under present law and under the standard deduction, earned income credit, and per capita tax credit provisions of the committee amendment for calendar years 1976, 1977, and 1978, respectively.

TABLE 1.—TAX REFORM AND EXTENSION OF TAX CUTS UNDER THE COMMITTEE AMENDMENT: ESTIMATED EFFECT ON FISCAL YEAR TAX RECEIPTS

[In millions of dollars]

	Fiscal year—					
	Transition quarter	1977	1978	1979	1980	1981
Tax reform program:						
Revenue raising provisions	184	2,536	2,819	3,090	3,316	3,612
Revenue reducing provisions	−227	−1,556	−2,899	−3,250	−3,444	−3,875
Total, tax reform program	−43	980	−80	−160	−128	−263
Extension of tax cuts:						
Standard deduction	−719	−4,146	−4,282	−4,495	−4,721	−4,956
Per capi'a tax credit	−1,675	−7,638	−367			
Earned income credit		−695	−1,335	−1,282	−1,230	−1,181
Total, individuals	−2,394	−12,479	−5,984	−5,777	−5,951	−6,137
Change in corporate tax rates	−262	−1,676	−2,221	−2,406	−2,579	−2,771
10-percent investment credit		−1,300	−3,306	−3,460	−3,617	−3,814
Total, business	−262	−2,976	−5,527	−5,866	−6,196	−6,585
Total, extension of tax cuts	−2,656	−15,455	−11,511	−11,643	−12,147	−12,722
Grand total	−2,699	−14,475	−11,591	−11,803	−12,275	−12,985

TABLE 2.—TAX REFORM AND EXTENSION OF TAX CUTS UNDER THE COMMITTEE AMENDMENT: ESTIMATED EFFECT ON CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

	Calendar year—					
	1976	1977	1978	1979	1980	1981
Tax reform program:						
Revenue raising provisions	2,223	2,987	3,068	3,251	3,606	3,976
Revenue reducing provisions	−1,029	−2,796	−3,128	−3,339	−3,742	−4,185
Total, tax reform program	1,194	191	−60	−88	−136	−209
Extension of tax cuts:						
Standard deduction	−2,153	−4,146	−4,353	−4,571	−4,800	−5,040
Per capita tax credit	−4,635	−5,045				
Earned income credit	−695	−1,335	−1,282	−1,230	−1,181	−1,134
Total, individuals	−7,483	−10,526	−5,635	−5,801	−5,981	−6,174
Change in corporate tax rates	−975	−2,140	−2,322	−2,507	−2,667	−2,898
10 percent investment credit		−3,255	−3,395	−3,566	−3,711	−3,971
Total, business	−975	−5,395	−5,717	−6,073	−6,378	−6,869
Total, extension of tax cuts	−8,458	−15,921	−11,352	−11,874	−12,359	−13,043
Grand total	−7,264	−15,730	−11,412	−11,962	−12,495	−13,252

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
MINIMUM AND MAXIMUM TAXES						
Minimum tax		980	1,077	1,187	1,306	1,437
Maximum tax		−49	−333	−401	−481	−577
Total		931	744	786	825	860
OTHER TAX SHELTER PROVISIONS						
Limitation on loss with respect to motion picture films, livestock, and certain crops to the amount for which the taxpayer is "at risk"	(2)	1	8	12	16	17
Limitation on deduction for depreciation with respect to equipment leasing to the amount for which the taxpayer lessor is "at risk"	(2)	6	14	17	17	14
Deduction for intangible drilling and development costs allowable only to taxpayers "at risk"	5	45	18	6	3	6
Recapture of depreciation on real property	(2)	9	18	28	38	56
Extension of 5-yr amortization, rehabilitated low-income housing	(2)	−1	−4	−8	−8	−7
Requirement that farm syndicates capitalize prepaid expenses	8	74	31	31	33	34
Scope of waiver of statute of limitations in case of activities not engaged in for profit	(2)	(2)	(2)	(2)	(2)	(2)
Termination of additions to excess deductions accounts under sec. 1251	(2)	(2)	(2)	(2)	(2)	(2)
Requirement that service company producing motion pictures, books, records, etc., capitalize its costs of production	3	26	19	9	4	4
Clarification of definition of "produced film rents"	(2)	(2)	(2)	(2)	(2)	(2)
Player contracts in case of sports enterprise	1	5	5	5	5	6
Certain partnership provisions	1	11	10	10	10	10
Treatment of prepaid interest	(2)	(2)	(2)	(2)	(2)	(2)
Repeal of limitation on investment interest deduction		−11	−12	−12	−13	−14
Total	18	165	107	98	105	126
BUSINESS RELATED INDIVIDUAL INCOME TAX PROVISIONS						
Deductions for expenses attributed to business use of homes, rental of vacation homes, etc	17	184	201	228	261	297
Deductions for attending foreign conventions	(2)	(2)	(2)	(2)	(2)	(2)
Change in tax treatment of qualified stock options	(2)	7	20	33	33	5
Legislators' travel expenses away from home	(2)	(2)	(2)	(2)	(2)	(2)
Total	17	191	221	261	294	302
SIMPLIFICATION						
Revision of tax tables for individuals						
$50 floor under gasoline tax deduction	27	285	287	306	324	343
Deduction for alimony allowed in determining adjusted gross income		−7	−44	−49	−54	−59
Revision of retirement income credit	−7	−101	−270	−270	−270	−270
Credit for child care expenses	−33	−346	−363	−399	−439	−483
Changes in exclusion for sick pay and certain military, etc., disability pensions	33	347	357	387	417	450
Moving expenses		−10	−67	−74	−81	−90
Accumulation trusts	(2)	(2)	(2)	(2)	(2)	(2)
Total	20	168	−100	−99	−103	−109

See footnotes at end of table.

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS—Continued

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
CAPITAL FORMATION						
Investment and foreign tax credits generated in 1976 refundable after expiration						
Investment and foreign tax credits expiring in 1976 extended through 1978		−14	−30	−16		
Additional 2-percent investment tax credit for ESOP's		−235	−584	−717	−837	−917
Investment tax credit for movie and television films	[4]−23	[4]−54	−5	−5	−5	−5
Investment tax credit allowed on ships financed from construction funds	−5	−21	−23	−29	−37	−45
Net operating losses and trafficking rules, option to elect 8-yr carryforward beginning with 1976 losses						
Railroad provisions:						
Increase 50-percent limitation to 100 percent, and FIFO investment tax credit		−29	−66	−65	−53	−41
Amortization over 50-yr period of railroad grading and tunnel bores placed in service before 1969	−5	−21	−18	−18	−18	−18
10-yr amortization of track placed after 1976	−1	−4	−10	−16	−21	−28
12-percent investment tax credit (compared to a 10-percent permanent rate)		−2	−5	−5	−5	−5
Allowance of 8-yr capital loss carryover in case of regulated investment companies	−1	−12	−21	−25	−34	−51
Total	−35	−392	−762	−896	−1,010	−1,110
ENERGY RELATED PROVISIONS						
Home insulation tax credit	−16	−192	−320	−272		
Solar energy and geothermal equipment tax credit	([2])	([2])	([2])	−4	−29	−31
Heat pump tax credit	([2])	−3	−5	−6		
Providing investment credit of 10 percent on qualifi ed business insulation placed in existing structures during 1977 and 1978		−11	−26	−15		
20 percent investment credit on solar energy and geothermal equipment in business structures through 1980 and 10 percent thereafter		([2])	([2])	([2])	([2])	([2])
Geothermal energy development, percentage depletion and expensing of intangibles		−7	−15	−16	−18	−21
Increasing investment credit to 12 percent on:						
Qualified waste burning equipment		−2	−5	−5	−5	−5
Oil shale production equipment		−4	−13	−15	−17	−20
Coal slurries		−7	−17	−22	−25	−28
Coal liquefication plants		([2])	([2])	([2])	([2])	([2])
Coal gasification plants		([2])	([2])	([2])	([2])	([2])
Coal mining equipment used in underground mines		−11	−27	−31	−36	−42
Equipment used to produce synthetic fuel from organic materials		([2])	([2])	([2])	([2])	([2])
Geothermal and seathermal equipment		([2])	([2])	([2])	([2])	([2])
Repealing investment credit on portable air-conditioning units and space heaters		([2])	([2])	([2])	([2])	([2])

See footnotes at end of table.

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS—Continued

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
ENERGY RELATED PROVISIONS—Con.						
Recycling tax credit		−9	−39	−155	−292	−345
Repealing excise tax on all buses and bus parts	−3	−19	−20	−21	−12	−12
Exempting from excise tax new oil used to produce rerefined lubricating oil	−1	−3	−3	−3	−3	−3
Repealing excise tax on special motor fuels for nonhighway use		(2)	(2)	(2)	(2)	(2)
Repealing tariff on oil exchanged with Canada						
Total	−20	−268	−490	−565	−437	−507
FOREIGN TAX PROVISIONS						
Income earned abroad by U.S. citizens living or residing abroad:						
(a) Denial of foreign tax credit on income eligible for the exclusion	1	11	10	10	10	10
(b) Taxation of nonexcluded income as if excluded income were in the tax base	3	26	25	25	25	25
(c) Inclusion of income earned abroad which is received outside of the country in which earned	(2)	(2)	(2)	(2)	(2)	(2)
(d) Permitting standard deduction returns a foreign tax credit for foreign taxes paid	−1	−7	−7	−7	−7	−7
(e) Exclusion of limited housing allowance	(2)	(2)	(2)	(2)	(2)	(2)
Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States	−21	−5	−5	−5	−5	−5
Foreign trusts having 1 or more U.S. beneficiaries to be taxed currently to grantor		2	10	10	10	10
Interest charge on accumulation distributions from foreign trusts		(2)	(2)	(2)	(2)	(2)
Excise tax on transfers of property to foreign persons to avoid Federal income tax (excise)	(2)	(2)	(2)	(2)	(2)	(2)
Amendment of provision relating to investment in U.S. property by controlled foreign corporations	(2)	(2)	(2)	(2)	(2)	(2)
Repeal of exclusion for earnings of less developed country corporations for purposes of sec. 1248	3	11	10	10	10	10
Exclusion from subpart F of certain earnings of insurance companies	−3	−11	−10	−10	−10	−10
Shipping profits of foreign corporations	(2)	(2)	(2)	(2)	(2)	(2)
Limitation on definition of foreign base company sales income in the case, of certain agricultural products	−5	−17	−15	−15	−15	−15
Requirement that foreign tax credit be determined on overall basis	10	41	35	42	50	50
Recapture of foreign losses		2	8	14	22	28
Dividends from less developed country corporations to be grossed up for purposes of determining U.S. income and foreign tax credit against that income	16	64	55	55	55	55
Treatment of capital gains for purposes of foreign tax credit	3	11	10	10	10	10
Foreign oil and gas extraction income:						
(a) Carryback of extraction taxes to 1975, 1976, and 1977	−2	−8	−10	−7	−3	
(b) Transitional rule for foreign oil-related losses	−6	−21	−6	5	5	5
(c) Definition of oil-related income:						
(1) Interest included in oil-related income		−40	−90	−90	−90	−90
(2) Oil-related income of a public utility		(2)	(2)	(2)	(2)	(2)
(3) Sale of stock in foreign corporations filing consolidated returns		(2)	(2)	(2)	(2)	

See footnotes at end of table.

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS—Continued

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
FOREIGN TAX PROVISIONS—Con.						
Foreign oil and gas extraction income—Continued						
(d) Percentage limitation on oil extraction taxes in the case of individuals	(2)	(2)	(2)	(2)	(2)	(2)
(e) Repeals rules denying creditability for foreign taxes where there isn't economic interest in oil	[5]—24	[5]—34	—40	—40	—40	—40
(f) Production-sharing contracts		—50				
Source of underwriting income determined by looking at the location of risk		(2)	(2)	(2)	(2)	(2)
Third tier foreign tax credit when sec. 960 applies		—4	—10	—10	—10	—10
Portfolio debt investments in United States of nonresident aliens and foreign corporations	(2)	—73	—137	—153	—167	—183
Changes in ruling requirements under sec. 367; certain changes in sec. 1248	(2)	(2)	(2)	(2)	(2)	(2)
Contiguous country branches of domestic life insurance companies		—4	—5	—5	—8	—8
Transitional rule for bond, etc., losses of foreign banks	(2)	(2)				
Tax treatment of corporations conducting trade or business in Puerto Rico and possessions of the United States	3	11	10	10	10	10
Repeal of Western Hemisphere Trade Corporations provisions	3	16	25	34	45	50
Repeal of provisions relating to China Trade Act Corporations	(2)	(2)	(2)	(2)	(2)	(2)
Amendments affecting DISC		84	306	431	422	495
International boycotts and foreign bribe-producted income	28	101	100	100	100	100
Total	8	133	239	411	419	490
ADMINISTRATIVE						
Withholding of Federal tax on gambling winnings	19	124	75	75	75	75
Sternmen considered self-employed for tax purposes[6]	(2)	(2)	(2)	(2)	(2)	(2)
Total	19	124	75	75	75	75
TAX EXEMPT ORGANIZATIONS						
The U.S. Court of Claims is also to have jurisdiction over declaratory judgments as to tax-exempt status of charitable organizations						
Code sec. 4941 transition rule for leased property	(2)	(2)	(2)			
Modification of set-aside rule of code sec. 4942		(2)	(2)	(2)	(2)	(2)
Private foundation mandatory payout lowered to 5 percent		(2)	(2)	(2)	(2)	(2)
Charitable remainder trusts and wills		—5	—5			
Private foundation excise tax on investment income reduced to 2 percent		(2)	—35	—36	—37	—38
Charitable organizations not subject to an unrelated business income tax on rental income from trade shows	(2)	(2)	(2)	(2)	(2)	(2)
County fairs are not subject to an unrelated business income tax	(2)	(2)	(2)	(2)	(2)	(2)
Total	(2)	—5	—40	—36	—37	—38

See footnotes at end of table.

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS—Continued

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
PENSION AND INSURANCE TAXATION						
Extension of IRA to nonemployed spouses		−3	−21	−23	−24	−25
Extension of H.R. 10 plans to low income recipients without regard to the 25-percent overall limitation	(2)	(2)	(2)	(2)	(2)	(2)
Limited employee retirement accounts[7]						
Extension of IRA to certain members of Armed Forces Reserves and National Guard	−6	−5	−5	−5	−5	−5
Permit tax-exempt organizations to invest annuity funds with closed-end investment firms						
Clarify that segregated asset accounts under qualified pension plans need not provide benefits in the form of annuities						
Extension of time for study of tax treatment of certain pension plans which provide nonqualified fringe benefits						
Insurance company consolidated tax returns			−25	−55	−49	−40
Inadvertent distribution by insurance companies	−2	−4	(2)	(2)	(2)	(2)
Insurance company deductions for nonparticipating policies	(2)	(2)	(2)	(2)	(2)	(2)
Total	−8	−12	−51	−83	−78	−70
REAL ESTATE INVESTMENT TRUSTS						
Real estate investment trusts		(2)	(2)	(2)	(2)	(2)
MISCELLANEOUS						
Tax treatment of certain cooperative housing associations	(2)	(2)	(2)	(2)	(2)	(2)
Tax treatment of certain disaster payments[8]	−4	−44	−42	−42	−42	−42
Tax treatment of certain 1972 disaster loans	−45	−15	−15	−15		
Tax treatment of certain debts owed by political parties, etc., to accrual basis taxpayers	(2)	(2)	(2)	(2)	(2)	(2)
Regulations relating to tax treatment of certain prepublication expenditures of publishers	(2)	(2)	(2)	(2)	(2)	(2)
Face amount certificates		(2)	(2)	(2)	(2)	(2)
Amendments affecting personal holding company taxation	(2)	(2)	(2)	(2)	(2)	(2)
Modification of WIN and welfare recipient employment credit	(2)	−3	−7	−11	−14	−17
Repeal excise tax on light duty truck parts installed at time of original purchase	−1	−3	−3	−3	−3	−3
Franchise transfers		(2)	(2)	(2)	(2)	(2)
Tips income		(2)	(2)	(2)	(2)	(2)
5-yr amortization and ½ investment tax credit allowed on pollution control equipment (existing facilities only)		52	75	−10	−95	−199
Fishermen's organizations are qualified as tax exempt organizations under 501(c)(5) of the Code		(2)	(2)	(2)	(2)	(2)
Subchapter S corporations		(2)	(2)	(2)	(2)	(2)
Permit redetermination of liability (Jan. 12, 1961 to Jan. 12, 1971) under "innocent spouse" rule	(2)	(2)	(2)			

See footnotes at end of table.

TABLE 3.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON FISCAL YEAR TAX RECEIPTS—Continued

[In millions of dollars]

	Transition quarter	1977	1978	1979	1980	1981
MISCELLANEOUS—Continued						
Cost of removing architectural barriers (up to $25,000 per year) to be expensed	−3	−11	−10	−10	−6	
Small retailers allowed percentage depletion on oil and gas production	−b	−18	−10	−10	−10	−10
Depletion amendments—65 percent rule regarding trusts	(2)	(2)	(2)	(2)	(2)	(2)
Depletion amendments—transfer in trust to new child	(2)	(2)	(2)	(2)	(2)	(2)
Federal collection of State income taxes						
Extension of exclusion of forgiven student loans	(2)	(2)	(2)	(2)	(2)	(2)
Tax exempt bonds issued to finance student loans	(3)	(3)	(3)	(3)	(3)	(3)
Simultaneous liquidation of parent and subsidiary		(2)	(2)	(2)	(2)	(2)
Prohibit State taxation of barges moving in inland waterways						
Contributions to utility construction	−3	−13	−11	−11	−11	−11
Total	−62	−55	−23	−112	−181	−282
Total tax reform program	−43	980	−80	−160	−128	−263
Revenue raising provisions	184	2, 536	2, 819	3, 090	3, 316	3, 612
Revenue reducing provisions	−227	−1, 556	−2, 899	−3, 250	−3, 444	−3, 875
Individuals	−15	1, 289	567	671	992	1, 011
Corporations	−28	−309	−647	−831	−1, 120	−1, 274

[1] This table dealing with tax reform has omitted extension of individual income tax reductions; continuation of 1975 change in corporate tax rates and increase in surtax exemption; and extension of 10-percent investment credit; and repeal and revision of obsolete rarely, used etc., provisions.

[2] Less than $5,000,000.

[3] The revenue impact of this provision cannot be estimated until the Bureau of Labor Statistics determines the deduction level.

[4] Reflects primarily liability of prior years.

[5] Includes 1975 liability.

[6] To be so considered since 12/31/71.

[7] The LERA provision of the House bill was not adopted by the Senate Finance Committee; however, a provision was adopted which would permit a participant in a Government plan to make deductible IRA contributions if the LERA provision should be adopted.

[8] At fiscal year 1975 level of payments.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
MINIMUM AND MAXIMUM TAXES						
Minimum tax	980	1, 077	1, 187	1, 306	1, 437	1, 580
Maximum tax		−324	−389	−467	−560	−672
Total	980	753	798	839	877	908
OTHER TAX SHELTER PROVISIONS						
Limitation on loss with respect to motion picture films, livestock, and certain crops to the amount for which the taxpayer is "at risk"	(2)	7	12	15	17	19
Limitation on deduction for depreciation with respect to equipment leasing to the amount for which the taxpayer lessor is "at risk"	4	13	17	18	14	11
Deduction for intangible drilling and development costs allowable only to taxpayers "at risk"	47	20	7	2	6	7
Recapture of depreciation on real property	5	15	25	35	50	65

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
OTHER TAX SHELTER PROVISIONS—Continued						
Requirement that farm syndicates capitalize prepaid expenses	78	30	31	33	34	36
Extension of 5-yr amortization, rehabilitated low-income housing	−1	−3	−6	−8	−8	−7
Scope of waiver of statute of limitations in case of activities not engaged in for profit	(2)	(2)	(2)	(2)	(2)	(2)
Termination of additions to excess deductions accounts under sec. 1251	(2)	(2)	(2)	(2)	(2)	(2)
Requirement that service company producing motion pictures, books, records, etc., capitalize its costs of production	26	20	10	4	4	4
Clarification of definition of "produced film rents"	(2)	(2)	(2)	(2)	(2)	(2)
Player contracts in case of sports enterprise	5	5	5	5	6	6
Certain partnership provisions	10	10	10	10	10	10
Treatment of prepaid interest	(2)	(2)	(2)	(2)	(2)	(2)
Repeal of limitation on investment interest deduction	−11	−12	−12	−13	−14	−15
Total	163	105	99	101	119	136
BUSINESS-RELATED INDIVIDUAL INCOME TAX PROVISIONS						
Deductions for expenses attributed to business use of homes, rental of vacation homes, etc.	172	196	224	255	291	331
Deductions for attending foreign conventions	(2)	(2)	(2)	(2)	(2)	(2)
Change in tax treatment of qualified stock options	4	18	32	38	9	−23
Legislators' travel expenses away from home	(2)	(2)	(2)	(2)	(2)	(2)
Total	176	214	256	293	300	308
SIMPLIFICATION OF INDIVIDUAL INCOME TAX PROVISIONS						
Revision of tax tables for individuals						
$50 floor under gasoline tax deduction	269	285	303	321	340	360
Deduction for alimony allowed in determining adjusted gross income		−44	−48	−53	−58	−64
Revision of retirement income credit	−68	−270	−270	−270	−270	−270
Credit for child care expenses	−325	−358	−393	−433	−476	−523
Changes in exclusion for sick pay and certain military, etc., disability pensions	327	353	382	412	445	481
Moving expenses		−66	−73	−80	−88	−97
Accumulation trusts	(2)	(2)	(2)	(2)	(2)	(2)
Total	203	−100	−99	−103	−107	−113
CAPITAL FORMATION						
Investment and foreign tax credits generated in 1976 refundable after expiration						
Investment and foreign tax credits expiring in 1976 extended through 1978		−30	−30			
Additional 2 percent investment tax credits for ESOP's		−523	−657	−792	−890	−952
Investment tax credit movie and television films	[4] −75	−5	−5	−5	−5	−5

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT[1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
CAPITAL FORMATION—Continued						
Investment, tax credit allowed on ships financed, from construction funds	−17	−21	−25	−33	−41	−49
Net operating losses and trafficking rules, option to elect 8-yr carryforwards beginning with 1976 losses						
Railroad provisions:						
Increase 50 percent limitation to 100 percent, and FIFO investment tax credit		−64	−69	−59	−47	−34
Amortization over 50-yr period of railroad grading and tunnel bores placed in service before 1969	−18	−18	−18	−18	−18	−18
10-yr, amortization of track placed after 1976	−2	−7	−13	−19	−25	−32
12 percent investment tax credit (compared to a 10 percent permanent rate)		−5	−5	−5	−5	−5
Allowance of 8-yr capital loss carryover in case of regulated investment companies	−10	−20	−25	−30	−50	−60
Total	−122	−693	−847	−961	−1, 081	−1, 155
ENERGY RELATED PROVISIONS						
Home insulation tax credit	−160	−320	−320			
Solar energy and geothermal equipment tax credit	(3)	(2)	(2)	−28	−36	
Heat pump tax credit	−2	−5	−7			
Providing investment credit of 10 percent on qualified business insulation placed in existing structures during 1977 and 1978		−25	−27			
20-percent investment credit on solar energy and geothermal equipment in business structures through 1980 and 10 percent thereafter		(3)	(3)	(3)	(3)	(3)
Geothermal energy development, percentage depletion, and expensing of intangibles		−15	−15	−17	−20	−22
Increasing investment credit to 12 percent on:						
Qualified waste burning equipment		−5	−5	−5	−5	−5
Oil shale production equipment		−10	−15	−15	−20	−20
Coal slurries		−15	−20	−25	−25	−30
Coal liquefication plants		(3)	(3)	(3)	(3)	(3)
Coal gasification plants		(3)	(3)	(3)	(3)	(3)
Coal mining equipment used in underground mines		−25	−29	−33	−39	−46
Equipment used to produce synthetic fuel from organic materials		(3)	(3)	(3)	(3)	(3)
Geothermal and seathermal equipment		(3)	(3)	(3)	(3)	(3)
Repealing investment credit on portable airconditioning units and space heaters		(3)	(3)	(3)	(3)	(3)
Recycling tax credit		−21	−61	−269	−320	−375
Repealing excise tax on all buses and bus parts	−9	−19	−21	−20	−12	−13
From excise tax new oil used to produce rerefined lubricating oil	−2	−3	−3	−3	−3	−3
Repealing excise tax on special motor fuels for nonhighway use	(3)	(3)	(3)	(2)	(2)	(3)
Repealing tariff on oil exchanged with Canada						
Total	−173	−463	−523	−415	−480	−514

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT [1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

	1976	1977	1978	1979	1980	1981
FOREIGN TAX PROVISIONS						
Income earned abroad by U.S. citizens living or residing abroad:						
(a) Denial of foreign tax credit on income eligible for the exclusion	10	10	10	10	10	10
(b) Taxation of nonexcluded income as if excluded income were in the tax base	25	25	25	25	25	25
(c) Inclusion of income earned abroad which is received outside of the country in which earned	(2)	(2)	(2)	(2)	(2)	(2)
(d) Permitting standard deduction returns a foreign tax credit for foreign taxes paid	−7	−7	−7	−7	−7	−7
(e) Exclusion of limited housing allowance	(2)	(2)	(2)	(2)	(2)	(2)
Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States	−25	−5	−5	−5	−5	−5
Foreign trusts having 1 or more U.S. beneficiaries to be taxed currently to grantor		−10	−10	−10	−10	−10
Interest charge on accumulation distributions from foreign trusts		(2)	(2)	(2)	(2)	(2)
Excise tax on transfers of property to foreign persons to avoid Federal income tax (excise)	(2)	(2)	(2)	(2)	(2)	(2)
Amendment of provision relating to investment in U.S. property by controlled foreign corporations	(2)	(2)	(2)	(2)	(2)	(2)
Repeal of exclusion for earnings of less developed country corporations for purposes of sec. 1248	10	10	10	10	10	10
Exclusion from subpart F of certain earnings of insurance companies	−10	−10	−10	−10	−10	−10
Shipping profits of foreign corporations	(2)	(2)	(2)	(2)	(2)	(2)
Limitation on definition of foreign base company sales income in the case of certain agricultural products	−15	−15	−15	−15	−15	−15
Requirement that foreign tax credit be determined on overall basis	35	35	35	50	50	50
Recapture of foreign losses		5	10	20	25	30
Dividends from less developed country corporations to be grossed up for purposes of determining U.S. income and foreign tax credit against that income	55	55	55	55	55	55
Treatment of capital gains for purposes of foreign tax credit	10	10	10	10	10	10
Foreign oil and gas extraction income:						
(a) Carryback of extraction taxes to 1975, 1976, and 1977	−5	−10	−10	−5		
(b) Transitional rule for foreign oil-related losses	−20	−15	5	5	5	5
(c) Definition of oil-related income:						
(1) Interest included in oil-related income	−90	−90	−90	−90	−90	−90
(2) Oil-related income of a public utility	(2)	(2)	(2)	(2)	(2)	(2)
(3) Sale of stock in foreign corporations filing consolidated returns	(2)	(2)	(2)	(2)	(2)	(2)
(d) Percentage limitation on oil extraction taxes in the case of individuals	(2)	(2)	(2)	(2)	(2)	(2)
(e) Repeals rules denying creditability for foreign taxes where there isn't economic interest in oil	• −80	−40	−40	−40	−40	−40
(f) Production-sharing contracts		−23	−27			
Source of underwriting income determined by looking at the location of risk		(2)	(2)	(2)	(2)	(2)

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT [1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
FOREIGN TAX PROVISIONS—Cont.						
3d-tier foreign tax credit when sec. 960 applies		−10	−10	−10	−10	−10
Portfolio debt investments in United States of nonresident aliens and foreign corporations	−8	−130	−145	−160	−175	−190
Changes in ruling requirements under sec. 367; certain changes in sec. 1248	([2])	([2])	([2])	([2])	([2])	([2])
Contiguous country branches of domestic life insurance companies	−8	−8	−8	−8	−8	−8
Transitional rule for bond, etc., losses of foreign banks	([2])					
Tax treatment of corporations conducting trade or business in Puerto Rico and possessions of the United States	10	10	10	10	10	10
Repeal of Western Hemisphere trade corporations provision	10	20	30	40	50	50
Repeal of provisions relating to China Trade Act Corporations	([2])	([2])	([2])	([2])	([2])	([2])
Amendments affecting DISC		468	422	387	518	636
International boycotts and foreign bribe-produced income	100	100	100	100	100	100
Total	87	348	372	362	498	606
ADMINISTRATIVE						
Withholding of Federal tax on gambling winnings	31	75	75	75	75	75
Sternmen, considered self-employed for tax purposes [6]	([2])	([2])	([2])	([2])	([2])	([2])
Total	31	75	75	75	75	75
TAX-EXEMPT ORGANIZATIONS						
The U.S. Court of Claims is also to have jurisdiction over declaratory judgments as to status of charitable organizations						
Code sec. 4941 transition rule for leased property	([2])	([2])				
Modification of set-aside rule of code sec. 4942	([2])	([2])	([2])	([2])	([2])	([2])
Private foundation mandatory payout lowered to 5 percent		([2])	([2])	([2])	([2])	([2])
Charitable remainder trusts and wills	−5	−5				
Private foundation excise tax on investment income reduced to 2 percent		−35	−36	−37	−38	−40
Charitable organizations not subject to an unrelated business income tax on rental income from trade shows	([2])	([2])	([2])	([2])	([2])	([2])
County fairs not subject to an unrelated business income tax	([2])	([2])	([2])	([2])	([2])	([2])
Total	−5	−40	−36	−37	−38	−40
PENSION AND INSURANCE TAXATION						
Extension of IRA to nonemployed spouses		−21	−22	−24	−25	−27

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT [1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
PENSION AND INSURANCE TAXATION—Continued						
Extension of H.R. 10 plans to low- ncome recipients without regard to the 25-percent overall limitation	[2]	(-)	[3]	[3]	[2]	[2]
Limited employee retirement accounts [7]						
Extension of IRA to certain members of Armed Forces Reserves and National Guard	−10	−5	−5	−5	−5	−5
Permit tax-exempt organizations to invest annuity funds with closed-end investment firms						
Clarify that segregated asset accounts under qualified pension plans need not provide benefits in the form of annuities						
Extension of time for study of tax treatment of certain pension plans which provide nonqualified fringe benefits						
Insurance company consolidated tax returns			−55	−56	−41	−39
Inadvertent distribution by insurance companies	−6	[3]	[3]	[3]	[3]	[3]
Insurance company deductions for nonparticipating policies	[3]	[3]	[3]	[3]	[3]	[3]
Total	−16	−26	−82	−85	−71	−71
REAL ESTATE INVESTMENT TRUSTS						
Amendments affecting REITS	[3]	[3]	[2]	[2]	[2]	[3]
MISCELLANEOUS						
Tax treatment of certain cooperative housing associations	[2]	[3]	[3]	[3]	[3]	[3]
Tax treatment of certain disaster payments [8]	−42	−42	−42	−42	−42	−42
Tax treatment of certain 1972 disaster loans	−45	−15	−15	−15		
Tax treatment of certain debts owed by political parties, etc., to accrual basis taxpayers		[2]	[2]	[2]	[3]	[2]
Regulations relating to tax treatment of certain prepublication expenditures of publishers and authors	[3]	[3]	[2]	[2]	[2]	[3]
Face amount certificates		[2]	[3]	[3]	[2]	[2]
Amendments affecting personal holding company taxation	[3]	[2]	[3]	[2]	[3]	[2]
Modification of WIN and welfare recipient employment credits	−1	−5	−9	−13	−16	−18
Repealing excise tax on light-duty truck parts installed at time of original purchase	−1	−3	−3	−3	−3	−3
Franchise transfers		[3]	[3]	[3]	[2]	[3]
Tips income	[3]	[2]	[3]	[3]	[2]	[3]
5-yr amortization and ⅜ investment tax credit allowed on pollution control equipment (existing facilities only)		115	26	−53	−146	−264
Fishermen's organizations are qualified as tax exempt organizations under 501(c)(5)						
Subchapter S corporations (increase to 15 stockholders)		[3]	[3]	[3]	[3]	[3]
Permit redetermination of liability (Jan. 12, 1961 to Jan. 12, 1971) under "innocent spouse" rule	[3]					

See footnotes at end of table.

TABLE 4.—TAX REFORM UNDER THE COMMITTEE AMENDMENT [1]—EFFECT ON CALENDAR YEAR TAX LIABILITY—Continued

[In millions of dollars]

	1976	1977	1978	1979	1980	1981
MISCELLANEOUS—Continued						
Cost of removing architectural barriers (up to $25,000 per year) to be expensed	−10	−10	−10	−10		
Small retailers allowed percentage depletion on oil and gas production	[4]−20	−10	−10	−10	−10	−10
Depletion amendments—65 percent rule regarding trusts	(2)	(2)	(2)	(2)	(2)	(2)
Depletion amendments—transfer in trust to new child	(2)	(2)	(2)	(2)	(2)	(2)
Federal collection of State income taxes						
Extension of exclusion of forgiven student loans	(2)	(2)	(2)	(2)	(2)	(2)
Tax exempt bonds issued to finance student loans	(2)	(2)	(2)	(2)	(2)	(2)
Simultaneous liquidation of parent and subsidiary		(2)	(2)	(2)	(2)	(2)
Prohibit State taxation of barges moving in inland waterways						
Contributions to utility construction	−11	−12	−10	−11	−11	−12
Total	−130	18	−73	−157	−228	−349
Total tax reform program	1,194	191	−60	−88	−136	−209
Revenue raising provisions	2,223	2,987	3,068	3,251	3,606	3,976
Revenue reducing provisions	−1,029	−2,796	−3,128	−3,339	−3,742	−4,185
Individuals	1,285	553	621	977	1,007	1,064
Corporations	−91	−362	−681	−1,065	−1,143	−1,273

[1] This table, dealing with tax reform, has omitted extension of individual income tax reductions; continuation of 1975 change in corporate tax rates and increase in surtax exemption; and extension of 10-percent investment credit; repeal and revision of obsolete, rarely used, etc., provisions.

[2] Less than $5,000,000.

[3] The revenue impact of this provision cannot be estimated until the Bureau of Labor Statistics determines the deduction level.

[4] Reflects primarily liability of prior years.

[5] Includes 1975 liability.

[6] To be so considered since 12/31/71.

[7] The LERA provision of the House bill was not adopted by the Senate Finance Committee; however, a provision was adopted which would permit a participant in a Government plan to make deductible IRA contributions if the LERA provision should be adopted.

[8] At fiscal year 1975 level of payments.

TABLE 5.—ESTIMATED DECREASE IN INDIVIDUAL INCOME TAX LIABILITY FOR 1976 UNDER THE TAX REDUCTION PROVISIONS OF THE COMMITTEE AMENDMENT [1]—BY ADJUSTED GROSS INCOME CLASS: 1975 INCOME LEVELS

	Number of returns affected (thousands)			Decrease in tax liability	
Adjusted gross income class	Total number with tax decrease	Number made nontaxable	Number shifting to the standard deduction	Amount (millions)	Percentage distribution (percent)
0 to $5,000	13,238	1,913	330	[2] $876	12.2
$5,000 to $10,000	20,073	1,212	1,503	1,967	27.5
$10,000 to $15,000	16,760	72	1,155	1,718	24.0
$15,000 to $20,000	10,676	24	850	1,315	18.4
$20,000 to $30,000	7,849	(3)	565	931	13.0
$30,000 to $50,000	2,424	(3)	104	266	3.7
$50,000 to $100,000	688	(3)	9	71	1.0
$100,000 and over	147	(3)	1	14	.2
Total	71,858	3,222	4,517	7,160	100.0

[1] Extension through the 2d half of 1976 of the $1,700–$2,100/16 percent/$2,400–$2,800 standard deduction; the 10-percent credit on earned income phased out between $4,000 and $8,000 of adjusted gross income; and the $35 per capita credit and its alternative 2-percent credit up to $180.

[2] Includes $100,000,000 to cover the credit on wage and salary and self-employment income of earners who are nonfilers under the 1970 filing requirements.

[3] Less than 500 returns.

Note: Details may not add to totals because of rounding.

TABLE 6. –ESTIMATED DECREASE IN INDIVIDUAL INCOME TAX LIABILITY FOR 1977 UNDER THE TAX REDUCTION PROVISIONS OF THE COMMITTEE AMENDMENT[1] –BY ADJUSTED GROSS INCOME CLASS: 1975 INCOME LEVELS

	Number of returns affected (thousands)			Decrease in tax liability	
Adjusted gross income class	Total number with tax decrease	Number made nontaxable	Number shifting to the standard deduction	Amount (millions)	Percentage distribution (percent)
0 to $5,000	15,086	3,795	890	[2] $1,739	17.9
$5,000 to $10,000	20,277	1,531	3,323	2,947	30.3
$10,000 to $15,000	16,816	56	1,807	1,925	19.8
$15,000 to $20,000	10,680	4	2,025	1,654	17.0
$20,000 to $30,000	7,849	([3])	1,025	1,078	11.1
$30,000 to $50,000	2,424	([3])	165	294	3.0
$50,000 to $100,000	688	([3])	18	76	.8
$100,000 and over	147	([3])	1	15	.2
Total	73,968	5,386	9,256	9,728	100.0

[1] Extension through 1977 of the standard deduction and earned income credit provisions of the committee amendmen and extension through June 30, 1977, of the per capita credit provision of the bill. See footnote 1 of table 5 for a brie description of the provisions.

[2] Includes $200,000,000 to cover the credit on wage and salary and self-employment income of earners who are nonfilers under the 1970 filing requirements.

[3] Less than 500 returns.

Note: Details may not add to totals because of rounding.

TABLE 7.—ESTIMATED DECREASE IN INDIVIDUAL INCOME TAX LIABILITY FOR 1978 UNDER THE TAX REDUCTION PROVISIONS OF THE COMMITTEE AMENDMENT[1]—BY ADJUSTED GROSS INCOME CLASS: 1975 INCOME LEVELS

	Number of returns affected (thousands)			Decrease in tax liability	
Adjusted gross income class	Total number witn tax decrease	Number made nontaxable	Number shifting to the standard deduction	Amount (millions)	Percentage distribution (percent
0 to $5,000	14,811	3,159	890	[2] $1,565	30.4
$5,000 to $10,000	17,659	1,023	3,323	1,953	37.9
$10,000 to $15,000	10,207	11	1,807	536	10.4
$15,000 to $20,000	5,311	([3])	2,025	667	12.9
$20,000 to $30,000	2,151	([3])	1,025	349	6.8
$30,000 to $50,000	322	([3])	165	68	1.3
$50,000 to $100,000	40	([3])	18	12	.2
$100,000 and over	4	([3])	1	1	([4])
Total	50,505	4,193	9,256	5,152	100.0

[1] Extension through 1978 of the standard deduction and earned income credit provisions of the committee amendment See footnote 1 of table 5 for a brief description of the provisions.

[2] Includes $200,000,000 to cover the credit on wage and salary and self-employment income of earners who are nonfilers u nder the 1970 filing requirements.

[3] Less than 500 returns.

[4] Less than 0.05 percent.

Note: Details may not add to totals because of rounding.

TABLE 8.—INDIVIDUAL INCOME TAX BURDEN[1] IN 1976 UNDER PRESENT LAW AND UNDER THE STANDARD DEDUCTION, EARNED INCOME CREDIT, AND PER CAPITA TAX CREDIT PROVISIONS OF THE COMMITTEE AMENDMENT: SINGLE PERSON AND MARRIED COUPLE WITH NO, 1, 2, AND 4 DEPENDENTS (ASSUMING DEDUCTIBLE PERSONAL EXPENSES OF 17 PERCENT OF INCOME

	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
Adjusted gross income[2]	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction
$3,000	$90	$43	$48	0	0	0	−$150	−$300	−$150	−$150	−$300	$150	−$150	−$300	$150
$5,000	425	364	62	$225	$130	$95	−55	−300	245	−150	−300	150	−150	−300	150
$6,000	605	534	72	383	284	99	146	−68	213	15	−200	215	−100	−200	100
$8,000	1, 000	905	96	724	608	116	577	456	122	431	294	137	155	0	155
$10,000	1, 407	1, 331	76	1, 084	948	136	949	821	129	797	651	146	481	308	173
$12,500	1, 906	1, 816	90	1, 484	1, 395	89	1, 326	1, 245	81	1, 188	1, 114	74	871	766	105
$15,000	2, 459	2, 369	90	1, 939	1, 849	90	1, 774	1, 684	90	1, 609	1, 519	90	1, 266	1, 161	105
$17,500	3, 055	2, 965	90	2, 426	2, 336	90	2, 239	2, 149	90	2, 066	1, 976	90	1, 721	1, 616	105
$20,000	3, 694	3, 604	90	2, 945	2, 855	90	2, 758	2, 668	90	2, 570	2, 480	90	2, 180	2, 075	105
$25,000	5, 140	5, 050	90	4, 080	3, 990	90	3, 870	3, 780	90	3, 660	3, 570	90	3, 225	3, 120	105
$30,000	6, 760	6, 670	90	5, 378	5, 288	90	5, 138	5, 048	90	4, 898	4, 808	90	4, 403	4, 298	105
$35,000	8, 535	8, 445	90	6, 848	6, 758	90	6, 578	6, 488	90	6, 308	6, 218	90	5, 753	5, 648	105
$40,000	10, 425	10, 335	90	8, 453	8, 363	90	8, 161	8, 071	90	7, 868	7, 778	90	7, 268	7, 163	105

[1] Computed without reference to the tax tables.
[2] Wage or salary and/or self-employment income.

Note: Details may not add to totals because of rounding.

TABLE 9.—INDIVIDUAL INCOME TAX BURDEN [1] IN 1977, UNDER PRESENT LAW AND UNDER THE STANDARD DEDUCTION, EARNED INCOME CREDIT, AND PER CAPITA TAX CREDIT PROVISIONS OF THE COMMITTEE AMENDMENT: SINGLE PERSON AND MARRIED COUPLE WITH NO, 1, 2, AND 4 DEPENDENTS (ASSUMING DEDUCTIBLE PERSONAL EXPENSES OF 17 PERCENT OF INCOME)

	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
Adjusted gross income [2]	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction
$3,000	$138	$60	$78	$28	0	$28	0	−$300	$300	0	−$300	$300	0	−$300	$300
$5,000	491	389	102	322	$165	157	$208	−262	470	$98	−300	398	0	−300	300
$6,000	681	569	112	484	319	165	362	−15	377	245	−144	389	$28	−200	228
$8,000	1,087	960	127	887	652	185	694	508	186	559	364	195	312	95	217
$10,000	1,482	1,407	76	1,152	1,012	140	1,010	877	133	867	721	146	586	413	173
$12,500	1,996	1,906	90	1,573	1,484	89	1,408	1,326	81	1,261	1,188	74	976	871	105
$15,000	2,549	2,459	90	2,029	1,939	90	1,864	1,774	90	1,699	1,609	90	1,371	1,266	105
$17,500	3,145	3,055	90	2,516	2,426	90	2,329	2,239	90	2,156	2,066	90	1,826	1,721	105
$20,000	3,784	3,694	90	3,035	2,945	90	2,848	2,758	90	2,660	2,570	90	2,285	2,180	105
$25,000	5,230	5,140	90	4,170	4,080	90	3,960	3,870	90	3,750	3,660	90	3,330	3,225	105
$30,000	6,850	6,760	90	5,468	5,378	90	5,228	5,138	90	4,988	4,898	90	4,508	4,403	105
$35,000	8,625	8,535	90	6,938	6,848	90	6,668	6,578	90	6,398	6,308	90	5,858	5,753	105
$40,000	10,515	10,425	90	8,543	8,453	90	8,251	8,161	90	7,958	7,868	90	7,373	7,268	105

[1] Computed without reference to the tax tables.
[2] Wage or salary and/or self employment income.

Note: Details may not add to totals because of rounding.

TABLE 10.—INDIVIDUAL INCOME TAX BURDEN[1] IN 1978 UNDER PRESENT LAW AND UNDER THE STANDARD DEDUCTION, EARNED INCOME CREDIT, AND PER CAPITA TAX CREDIT PROVISIONS OF THE COMMITTEE AMENDMENT: SINGLE PERSON AND MARRIED COUPLE WITH NO, 1, 2, AND 4 DEPENDENTS (ASSUMING DEDUCTIBLE PERSONAL EXPENSES OF 17 PERCENT OF INCOME)

	Tax liability														
	Single person			Married couple with no dependents			Married couple with 1 dependent			Married couple with 2 dependents			Married couple with 4 dependents		
Adjusted gross income[2]	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction	Under present law	Under the amendment	Reduction
$3,000	$138	$78	$60	$28	0	$28	0	—$300	$300	0	—$300	$300	0	—$300	—$300
$5,000	491	415	76	322	$200	122	$208	—209	417	$98	—300	398	0	—300	300
$6,000	681	605	76	484	354	130	362	38	325	245	—74	319	$28	—200	228
$8,000	1, 087	1, 016	71	837	696	141	694	561	134	559	434	125	312	200	112
$10,000	1, 482	1, 482	0	1, 152	1, 076	76	1, 010	934	76	867	791	76	586	518	68
$12,500	1, 996	1, 996	0	1, 573	1, 573	0	1, 408	1, 408	0	1, 261	1, 261	0	976	976	0
$15,000	2, 549	2, 549	0	2, 029	2, 029	0	1, 864	1, 864	0	1, 699	1, 699	0	1, 371	1, 371	0
$17,500	3, 145	3, 145	0	2, 516	2, 516	0	2, 329	2, 329	0	2, 156	2, 156	0	1, 826	1, 826	0
$20,000	3, 784	3, 784	0	3, 035	3, 035	0	2, 848	2, 848	0	2, 660	2, 660	0	2, 285	2, 285	0
$25,000	5, 230	5, 230	0	4, 170	4, 170	0	3, 960	3, 960	0	3, 750	3, 750	0	3, 330	3, 330	0
$30,000	6, 850	6, 850	0	5, 458	5, 468	0	5, 228	5, 228	0	4, 988	4, 988	0	4, 508	4, 508	0
$35,000	8, 625	8, 625	0	6, 938	6, 938	0	6, 668	6, 668	0	6, 398	6, 398	0	5, 858	5, 858	0
$40,000	10, 515	10, 515	0	8, 543	8, 543	0	8, 251	8, 251	0	7, 958	7, 958	0	7, 373	7, 873	0

[1] Computed without reference to the tax tables.
[2] Wage or salary and/or self-employment income.

Note: Details may not add to totals because of rounding.

IV. GENERAL EXPLANATION

A. LIMITATION ON ARTIFICIAL LOSSES

The House bill included a limitation on artificial losses (LAL). Under LAL, certain deductions, such as interest and taxes during the construction period of a building, accelerated depreciation, prepaid feed expenses and intangible drilling costs would only be allowed against related income. For example, accelerated depreciation on a building would be allowed as a deduction only to the extent of income from real estate and, therefore, could not be used to reduce the tax on wage or other income. LAL was applied to oil and gas wells other than exploratory wells, real estate, farm operations, equipment leasing, movies and sports franchises. In the case of farm operations and real estate, the limit on use of certain deductions was applied on a consolidated basis; in the other areas it was applied on a property-by-property basis.

The committee amendment deletes LAL for two principal reasons: its extreme complexity and its adverse economic impact.

The complexity results from the need for taxpayers to keep records over a period of several years in order to keep track of their deferred deductions and also from the need to distinguish between related income and other income. The determination of related income is especially difficult when LAL is applied on a property-by-property basis. The committee is very concerned about the trend toward greater complexity in the tax system and believes that LAL would have been an important contribution to that trend.

From the economic standpoint, the problem with LAL was that it failed to distinguish between the actual abuses of tax shelters, cases where economically inefficient investments are undertaken purely for tax reasons, and the situations where tax incentives provide important encouragement to economically worthwhile investments. By disallowing deductions in both cases, LAL would have eliminated many productive investments, a serious mistake at a time of high unemployment. This problem would have been especially serious for the real estate and oil and gas industries, since we are falling far short of reaching our housing goals and our goal of energy independence.

The committee believes that curbing the abuses of tax shelters with the minimum tax, maximum tax and specific tax shelter provisions is a better approach, both in terms of simplicity and economic impact.

B. OTHER TAX SHELTER PROVISIONS

1. Real Estate

a. Recapture of Depreciation on Real Property (sec. 201 of the bill and sec. 1250 of the Code)

Present law

Under present law, net gains on the sale of real property used in a trade or business (with certain exceptions) are taxed as capital gain, and losses are generally treated as ordinary losses. However, gain on the sale of depreciable real property (buildings) in the cases indicated below is "recaptured" and taxed as ordinary income rather than capital gain to the extent that the gain represents accelerated depreciation allowed or allowable in excess of the amount computed under the straight-line method of depreciation.

Depreciation recapture was first enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain. However, the 1962 recapture provision (sec. 1245 of the code) only taxed gain on a sale of most tangible personal property as ordinary income to the extent of depreciation taken on the property after December 31, 1962. In 1964, recapture rules were extended to real property (buildings) but in this case gain on sale would be taxed as ordinary income to the extent of the accelerated depreciation taken on that property after December 31, 1963. In addition, there was a gradual reduction of the amount to be recaptured. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recaptured was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules on real property were further modified as to post-1969 depreciation. Under that Act, in the case of residential real property generally and property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, post-1969 depreciation in excess of straight-line is fully recaptured at ordinary income rates (to the extent of gain) if the property has been held for less than 100 months (8 years and 4 months). For each month the property is held over 100 months, there is a one percent reduction in the amount of post-1969 depreciation that is recaptured. Thus, there will be no recapture of any depreciation if the property is held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post-1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of Federal, State, and locally assisted housing projects constructed or acquired before January 1, 1976 (such as the FHA 221(d)(3) and the FHA 236 programs) the pre-1969 recapture rules on real property are retained.[1] However, if the property is constructed or acquired after December 31, 1975, the regular post-1969 rules previously discussed above with respect to residential property apply (i.e., a one percent reduction per month after 100 months).

Reasons for change

As previously discussed, the present tax treatment of real estate is used by some taxpayers in high marginal income tax brackets to avoid payment of income tax on substantial portions of their economic income. This is principally achieved in real estate by allowing certain accelerated deductions, such as accelerated depreciation and interest paid during the construction period, to create substantial tax losses, thereby sheltering other income of the taxpayer.

Under present law, deductions for accelerated depreciation generally exceed the actual decline in the economic value of the property. Further, accelerated methods of depreciation make it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. When the property is sold, the excess of the amount realized over the adjusted basis is treated as capital gain to the extent that the recapture provisions do not apply. By holding residential property for 16⅔ years before sale, the taxpayer can arrange to have all gain resulting from excess depreciation (which was previously offset against ordinary income) taxed at the preferential capital gain rates without any recapture.[2] The tax advantages from converting ordinary income into capital gain increase as the taxpayer's marginal income tax rate increases.

In addition, allowing deductions for interest paid during the construction period in effect permits the expensing of an important capital cost, rather than it being spread over the life of the property. The effect of this also is to shelter other income during the early years of a project.

To reduce the opportunities to avoid income taxes as a result of allowing accelerated depreciation for real property to convert ordinary income into capital gain, the committee believes it is appropriate to extend the present recapture rules on commercial property to cover residential real estate.

The tax shelter effect of construction period interest is dealt with in the committee amendment by including these deductions in the minimum tax base.

Explanation of provisions

Under the committee amendment, when residential real estate is sold, any gain will be fully recaptured as ordinary income to the extent

[1] That is, with respect to these projects, accelerated depreciation will be fully recaptured at ordinary income rates only if the property has been held for not more than 20 months. (If the property is sold within 12 months, all of the depreciation is recaptured.) For each month the property is held over 20 months, there is a 1 percent per month reduction in the amount of accelerated depreciation recaptured. Thus, there will be no recapture if the property is held for a period of 120 months (10 years).

[2] In the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, there is no recapture if the property is held for 10 years before sale.

of post-1975 depreciation in excess of straight-line depreciation, except for a special transitional rule in the case of certain low-income housing, as described below. (This rule already applies in the case of commercial property.) Thus, all accelerated depreciation attributable to taxable years beginning after December 31, 1975, would be fully recaptured to the extent of any gain regardless of the date the property was constructed. As under present law, all of the depreciation taken, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months.

Special rules are provided in the case where a portion of the gain from the sale or exchange of property is subject to recapture under both the existing recapture rules and the new recapture rules. Under these special rules, first, accelerated depreciation attributable to taxable years beginning after December 31, 1975, will be recaptured (to the extent of any gain); second, accelerated depreciation attributable to taxable years beginning after December 31, 1969, and before January 1, 1976, will be recaptured (to the extent of any additional gain not recaptured under the new rules) and third, accelerated depreciation attributable to taxable years beginning after December 31, 1963, and before January 1, 1970 will be recaptured (to the extent of any remaining gain not recaptured).

The provisions of the committee amendment relating to recapture are the same as the provisions of the House bill except with respect to low-income housing. In the case of low-income housing, the committee amendment provides a special transitional rule in the case of 4 categories of low-income rental housing:

(1) Federally assisted housing projects with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act (or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws);

(2) housing financed or assisted by direct loan or insured under Title V (sec. 515) of the Housing Act of 1949 (or housing financed or assisted by direct loan or insured under similar provisions of State or local laws);

(3) low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower income families; and

(4) low-income rental housing with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k).

The House bill did not include within the definition of low-income rental housing, housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949 (or housing financed or assisted by direct loan or insured under similar provisions of State or local laws).

As to these 4 categories of real property, the committee amendment provides that in the case where the construction (or rehabilitation) of such low-income housing begins after December 31, 1981, (other than pursuant to a binding contract in existence on such date) all accelerated depreciation will be recaptured to the extent of any gain from the sale or exchange of the property. As under present law, all depreciation (including straight-line) will be recaptured if the property has not been held for more than 12 months.

In the case where the construction (or rehabiliation) of the property commenced before January 1, 1982 (or pursuant to a binding contract entered into before such date), the amount of recapture attributable to accelerated depreciation taken after December 31, 1975, will be reduced after an initial 100-month holding period. For each month the property is held over 100 months, there will be a 1 percent per month reduction in the amount of accelerated depreciation attributable to taxable years after December 31, 1975, which is recaptured. Thus, after 200 months (16⅔ years) there will be no recapture. This is the recapture rule provided in the House bill for low-income housing with respect to accelerated depreciation taken after December 31, 1975.

Special rules similar to those discussed above for residential property generally are provided for low-income housing where a portion of the gain from the sale or exchange of such property is subject to recapture under both the existing recapture rules and the new recapture rules.

In addition, the committee amendment provides that where real property is disposed of by reason of foreclosure or similar proceedings, the monthly percentage reduction of the amount of accelerated depreciation subject to recapture shall terminate as of the date on which such proceedings were begun. The application of this provision can be illustrated by the following example:

Example.—Assume that on June 1, 1976, the taxpayer acquired certain low-income rental property which qualified for the special recapture treatment discussed above (i.e., a one percent per month reduction after 100 months). On April 1, 1987 (130 months after the property was placed in service) foreclosure proceedings were instituted with respect to the property and on December 1, 1988 (150 months after the property was placed in service) the property was disposed of pursuant to the foreclosure proceedings. The applicable percentage reduction will be 30 percent rather than 50 percent since the percentage reductions would cease to apply on April 1, 1987 (the date that foreclosure proceedings were instituted).

Effective date

The provisions relating to the complete recapture of accelerated depreciation on residential property (other than low-income housing) are to apply to accelerated deprecation attributable to taxable years beginning after December 31, 1975. In the case of low-income housing, full recapture is to apply with respect to accelerated depreciation where the construction (or rehabilitation) begins after December 31, 1981. However, where the construction of low-income housing begins before January 1, 1982, the 100-month recapture rule (1 percent per month reduction in the amount recaptured after 100 months) is to apply with respect to accelerated depreciation attributable to taxable years beginning after December 31, 1975. The provisions relating to the percentage reduction in the case of dispositions pursuant to foreclosure or similar proceedings is to apply with respect to proceedings which begin after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $9 million in fiscal year 1977, $18 million in fiscal year 1978, and $56 million in fiscal year 1981.

b. Extension of 5-year Amortization for Low-income Rental Housing (sec. 201 of the bill and sec. 167 of the Code)

Present law

Under present law, special depreciation rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the code). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Under current Treasury regulations occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of Housing and Urban Development (HUD) for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.[3]

Under the special depreciation rules for low income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Only the aggregate rehabilitation expenditures as to any housing which do not exceed $15,000 per dwelling unit qualify for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Reasons for change

In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low-income rental housing to eliminate the shortage in the area. However, the special tax incentive for rehabilitation expenditures for low-income rental housing under present law expired on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects may be curtailed. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provision for low-income housing should be extended.

Explantion of provision

The committee amendment provides a two-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low income rental housing and increases the amount of rehabilitation expenditures that can be taken into account per dwelling unit from $15,000 to $20,000. These provisions are essentially the same as those provided in the House bill.

[3] The current income limits prescribed by the Secretary of HUD for a family of four are $15,400 in Washington, D.C., $13,700 in Chicago, and $11,900 in Los Angeles. Thus, 90 percent of these limits are $13,800, $12,330, and $10,710 respectively.

However, the committee amendment modifies the House bill with respect to the new expiration date (January 1, 1978) of the special 5-year rule. Under the committee amendment, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1978, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1977. Under the House bill, only expenditures actually paid or incurred before January 1, 1978, would qualify.

In addition, the committee amendment modifies the definition of families and individuals of low and moderate income by providing that the eligible income limits would be determined in a manner consistent with those presently established for the Leased Housing Program under Section 8 of the United States Housing Act of 1937, as amended. Under the House bill (as under present law), the eligible income limits are determined in a manner consistent with the policies of the Housing and Urban Development Act of 1968.

Effective date

The provisions relating to the 2-year extension apply to expenditures paid or incurred with respect to low-income rental housing after December 31, 1975, and beforeJanuary 1, 1978 (including expenditures made pursuant to a binding contract entered into before January 1, 1978). The provisions increasing the amount of expenditures that can be depreciated under the special 5-year rule shall apply to expenditures incurred after December 31, 1975.

Revenue effect

It is estimated that this provision will result in a decrease in tax liability of $1 million for calendar year 1976, $3 million for 1977, and $7 million for 1981.

2. Limitation of Loss to Amount At-Risk (sec. 202 of the bill and sec. 465 of the Code)

Present law

Generally, the amount of depreciation or other deductions which a taxpayer is permitted to take in connection with a property is limited to the amount of his basis in the property. In addition, similar statutory limitation rules are found in sections 704(d) and 1374(c) (2) for owners of partnership interests and shareholders in subchapter S corporations where the partners and shareholders, rather than the entity, are taxed on the income or loss of the entity.

The starting point for determining a taxpayer's adjusted basis in a productive activity or enterprise is generally the taxpayer's cost for the productive assets (secs. 1011, 1012). In the case of a productive activity engaged in through a partnership or subchapter S corporation, the investor's adjusted basis in his stock or partnership interest is generally based on the amount of money and his adjusted basis in other property contributed to the enterprise (secs. 722, 358). The investor's basis in a partnership interest or subchapter S corporation stock is increased by his portion of the income of these entities, and decreased by his portion of their losses, in recognition of the fact that the income and losses are flowed through to the investor for tax purposes, rather than being taxed to the entity.

The liabilities of a productive activity may also have an effect upon an investor's adjusted basis in the activity. Thus, a taxpayer's basis in a property includes the portion of the purchase price which is financed even if the taxpayer is not personally liable on the loan and the lender must look solely to the financed property for repayment of the loan.

In the case of a subchapter S corporation, liabilities of the corporation increase a shareholder's adjusted basis in the stock to the extent that the liability is owed to that particular shareholder (secs. 1374(c)(2), 1376).

In the case of partnerships, in general, a partner's share of the liabilities of the partnership is considered to be a contribution of money by him to the partnership (sec. 752). Since a partner's contributions to the partnership increase the adjusted basis of his partnership interest (sec. 705), the partner's adjusted basis reflects not only his contributions in money and other property, but also his share of partnership liabilities. This rule applies regardless of whether the particular liability is owed to one or more of the partners or to an unrelated party. The rule is premised upon the assumption that the partner may be held personally liable for the debts of the partnership and since he may be called on to, in effect, make additional contributions of money to cover these liabilities, the adjusted basis of his partnership interest should reflect this potential risk of additional liability.

However, limited partners in a limited partnership may not be held responsible for partnership debts, and their potential personal liability is confined to the amount of their partnership contribution in money or other property. Since a limited partner does not have unlimited personal liability, the basis of his partnership interest is not usually increased to reflect borrowing by the partnership. There is, however, an exception to this rule. The regulations provide that where none of the partners have personal liability for a partnership obligation, all of the partners, including limited partners, share in the liability (Reg. § 1.752-1(e)). Since a limited partner is deemed to have a share of such nonrecourse liabilities, the adjusted basis of his partnership interest is increased under the generally applicable partnership provisions.

This approach to nonrecourse partnership liabilities arises from a judicially developed principle known as the *Crane* rule. The *Crane* rule is derived from the Supreme Court's reasoning in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), where it was held that an owner's adjusted basis in a parcel of real property included the amount of a nonrecourse mortgage on the property, under which the mortgagee-lender could seek a recovery of its loan only from the property. (It is because of the *Crane* rule that nonrecourse indebtedness is generally included in an investor's adjusted basis, as indicated above, in a business or productive property.)

Also, in general, the existence of protection against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement or similar arrangement does not impose a limitation on the amount of losses a taxpayer may deduct in the early taxable years of an activity.

Reason for change

The typical tax shelter operates as a limited partnership with individual investors participating as limited partners. Virtually all of the equity capital for the activity is contributed by the limited partners with the major portion of remaining operating funds (generally 75 percent or more of the total capital) for the partnership financed through nonrecourse loans.

When an investor is solicited for a tax shelter activity, it has become common practice to promise the prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources. The committee believes that it is not equitable to allow these individual investors to defer tax on income from other sources through losses generated by tax sheltering activities, to the extent the losses exceed the amount of actual investment the taxpayer has placed at risk in the transaction.

The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic risk arises under present law primarily through the use of nonrecourse financing not only by limited partnerships, but also by individuals and subchapter S corporations. The ability to deduct tax losses in excess of economic risk also may arise through guarantees; stop-loss agreements, guaranteed repurchase agreements, and other devices used by partnerships, individuals and subchapter S corporations.

Nonrecourse leveraging of investments and other risk limiting devices which produce tax savings in excess of amounts placed at risk substantially alter the economic substance of the investments and distort the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of investment funds.

The House bill applied the limitation on artificial losses (LAL) provision to tax sheltering activities in an attempt to limit the deductions available to the amount of income earned in the year. As indicated above, the committee is concerned that the LAL provision in the House bill is too complicated and would present difficulties in administration. In addition, the committee believes that a significant problem in tax shelters is the use of nonrecourse financing or other devices as a result of which the taxpayer is not personally liable for amounts which are attributed to his basis for purposes of the tax benefits from the investments. Consequently, the committee amendment provides an "at risk" rule which the committee believes deals more directly with the abuses in tax shelters. In addition, as indicated in the minimum tax section above, the committee amendment applies the minimum tax to the tax preferences related to these tax shelter activities in order to make sure that taxpayers in these tax shelter investments would at least pay some minimum tax. The committee believes that by dealing with tax shelters in these two ways (combined with the modifications provided in the maximum tax, as indicated in that section above), the committee amendment eliminates the abuses in tax shelters in their use of various limited risk financing techniques, while at the same time continuing the incentives which are believed appropriate in certain areas, but providing a minimum tax on these preferences to ensure that they do not allow taxpayers to avoid all tax in these activities.

Explanation of provision

To prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of activities, the committee amendment provides that the amount of any loss (otherwise allowable for the year under present law) which may be deducted in connection with one of these activities, cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. This "at risk" limitation applies to the following activities: (1) farming; (2) exploring for, or expoiting, oil and gas resources; (3) the holding, producing, or distributing of motion picture films or video tapes; and (4) equipment leasing. The limitation applies to all taxpayers (other than corporations which are not subchapter S corporations) including individuals and sole proprietorships, estates, trusts, shareholders in subchapter S corporations, and partners in a partnership which conducts an activity described in this provision.

The risk limitation is to apply on the basis of the facts existing at the end of each taxable year.[1]

In applying the at risk limitation, the amount of any loss which is allowable in a particular year reduces the taxpayer's risk investment (but not below zero) as of the end of that year and in all succeeding taxable years with respect to that activity. Thus, if a taxpayer has a loss in excess of his at risk amount, the loss disallowed will not be allowed in a subsequent year unless the taxpayer increases his at risk amount.

Losses which are suspended under this provision with respect to a taxpayer because they are greater than the taxpayer's investment which is "at risk" are to be treated as a deduction with respect to the activity in the following year. Consequently, if a taxpayer's amount at risk increases in later years, he will be able to obtain the benefit of previously suspended losses to the extent that such increases in his amount at risk exceed his losses in later years.

The at risk limitation also applies regardlesss of the method of accounting used by the taxpayer and regardless of the kind of deductible expenses which contributed to the loss.

The at risk limitation is only intended to limit the extent to which certain losses in connection with the covered activities may be deducted in the year claimed by the taxpayer. The rules of this provision do not apply for other purposes, such as the determination of basis. Thus, a partner's basis in his interest in the partnership will generally be unaffected by this provision of the committee amendment.[2] However, for purposes of determining how much, if any, of his share of a partnership loss a partner may deduct in any year, this provision of the

[1] If the partners in a partnership are personally liable on a loan to the partnership at the time the loan is initially made, but if the loan provides that the debt becomes nonrecourse if certain later events occur (e.g. if an orchard reaches a certain stage of development), the partners are exposed to the risk of loss during the period they are personally liable on the loan. They cease to be exposed to loss from and after the time that the loan becomes nonrecourse.

[2] The partner's basis will increase to the extent that his distributive share of partnership income is retained by the partnership and used for such purposes as repaying the partnership's loan. The partner's basis for his interest in the partnership will then decrease in an equal amount by the reduction in his share of the partnership liability.

committee amendment overrides the existing partnership rules of section 704(d) and related provisions, including regulations section 1.752-1(e).[3]

For purposes of this provision, a taxpayer is generally to be considered "at risk" with respect to an activity to the extent of his cash and the adjusted basis of other property contributed to the activity, as well as any amounts borrowed for us in the activity with respect to which the taxpayer has personal liability for payment from his personal assets. (Also, as discussed further below, a taxpayer is at risk to the extent of his net fair market value of personal assets which secure nonrecourse borrowings.)

A taxpayer is not to be considered at risk with respect to the proceeds from his share of any nonrecourse loan used to finance the activity or the acquisition of property used in the activity. In addition, if the taxpayer borrows money to contribute to the activity and the lender's recourse is either the taxpayer's interest in the activity or property used in the activity, the amount of the proceeds of the borrowing are to be considered amounts financed on a nonrecourse basis and do not increase the taxpayer's amount at risk.

Also, under these rules, a taxpayer's capital is not "at risk" in the business, even as to the equity capital which he has contributed to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer.[4] Under this concept, an investor is not "at risk" if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.

In livestock feeding operations, for example, some commercial feedlots have offered to reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such "stop loss" orders, the investor is to be considered "at risk" (for purposes of this provision) only to the extent of the portion of his capital against which he is not entitled to reimbursement. Similarly, in some livestock breeding investments carried on through a limited partnership, the partnership agrees with a limited partner that, at the partner's election, it will repurchase his partnership interest at a stated minimum dollar amount (usually less than the investor's original capital contribution). In situations of this kind, the partner is to be considered "at risk" only to the extent of the portion of the amount otherwise at risk over and above the guaranteed repurchase price.[5]

[3] If no partner is personally liable to repay any part of a debt obligation incurred by the partnership, no partner may treat such part of the debt as part of his capital at risk in the partnership for purposes of this provision.

Similarly, even if one or more partners is personally liable on part or all of a partnership debt, other partners who have no personal liability may not treat any part of the debt as part of their risk capital.

In the case of a partnership, special allocations of deductions by agreement among the partners may not increase the amount of a loss deduction allowable to any partner for a taxable year beyond the amount which that partner is "at risk" in the partnership for the same year.

[4] The normal buy-sell agreement between partners which is carried out when a partner retires or dies is not the kind of agreement which prevents a partner from being at risk.

[5] A limited partner who assumes personal liability on a loan to the partnership (made by a bank or other lender), but who obtains the general partner's agreement to indemnify him against some or all of any loss arising under such personal liability, is at risk only with respect to the excess of the amount of the indebtedness over the maximum amount covered by the indemnity agreement.

Similarly, if a taxpayer is personally liable on a mortgage but he separately obtains insurance to compensate him for any payments which he must actually make under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed.[6] The taxpayer will be able to include in the amount which he has at risk any amount of premium which he had paid from his personal assets with respect to the insurance. However, a taxpayer who obtains casualty insurance or insurance protecting himself against tort lability will not be considered "not at risk" solely because of such insurance protection.

A taxpayer's at risk amount is generally to include amounts borrowed for use in the activity which is secured by property other than property used in the activity. For example, if the taxpayer uses personally-owned real estate to secure nonrecourse indebtedness, the proceeds from which are used in an equipment leasing activity, the proceeds may be considered part of the taxpayer's at risk amount. In such a case, the portion of the proceeds which increases the taxpayer's at risk amount is to be limited by the fair market value of the property used as collateral (determined as of the date the property is pledged as security), less any prior (or superior) claims to which the collateral is subject.

The committee amendment contains a special rule which prevents a taxpayer increasing from his at risk amount through collateral in cases where the collateral was financed directly or indirectly by indebtedness which is secured by any property used in the acivity. The intent of this rule is to prevent a taxpayer from increasing his at risk amount by cross-collateralizing property used in the activity with other property not used in the activity.

The rules treating a taxpayer as being "at risk" with respect to the net value of pledged property also do not apply to nonrecourse loans if the lender has an interest, other than as a creditor, in the activity or if the lender is related to the taxpayer (within the meaning of section 267(b)).

In the case of a partnership, a partner is generally to be treated as at risk to the extent that his basis in the partnership is increased by his share of partnership income.[7] The fact that partnership income is then used to reduce the partnership's nonrecourse indebtedness would have no effect on the partner's amount at risk. (The reduction of nonrecouse indebtedness would still, of course, reduce his basis in his partnership interest for purposes other than the at risk limitation.) [8]

[6] For purposes of this rule, it will be assumed that a loss-protection guarantee, repurchase agreement or insurance policy will be fully honored and that the amounts due thereunder ill be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.

[7] However, his at risk amount must be reduced by any personal nonrecourse indebtedness reflected in his basis and any other appropriate stop-loss orders, etc., which affect his risk or that of his partnership.

[8] For example, assume partner A's basis in the partnership is $60X (consisting of $10X which is "at risk" and $50X which represents the portion of the partnership's nonrecourse loan which is allocated to partner A's basis). If the partnership has $5X of taxable income for the taxable year which is allocated to partner A, his total basis is increased to $65X (his at risk basis increases to $15X while his basis which is not at risk remains at $50X). If the partnership in the following year makes a $5X payment to the bank on its loan, the partner's basis is reduced to $60X (his at risk basis remains at $15X while his *basis which is not at risk* is reduced to $45X).

If the partnership, instead of retaining the income, makes actual distributions of the income to a partner in the taxable year, the amount distributed reduces the partner's amount at risk.

In general, in the case of an activity engaged in by an individual, each motion picture film or video tape, item of leased equipment, farm, or oil and gas property is treated as a separate activity. However, in the case of a partnership or subchapter S corporation, all of the activities in the same category (*i.e.*, all motion picture films and video tapes) are to be treated as one activity.[9] Thus, the loss from the activity for any partner is that partner's loss from the partnership and (assuming no stop-loss orders, etc.) his at risk amount is generally the amount of his cash or other contribution to the partnership, plus his share of the proceeds of any indebtedness with respect to which the partner has no limitation on liability. Since in these cases the partnership is treated as a single activity, only property of a partner which is not used in the partnership activity can be considered collateral which increases the partner's risk amount.

The at risk limitation applies only to tax losses produced by expense deductions which are not disallowed by reason of some other provision of the code. For example, if a prepaid interest expense is suspended under the prepaid interest limitation (sec. 207 of the committee amendment), that expense will not enter into the computation of the tax loss subject to the risk limitation. When the interest accrues and becomes deductible, the expense may at that time be deferred under this provision of the committee amendment. Similarly, if a deduction is deferred pursuant to the farming syndicate rules (described in the farm section below), that deduction will enter into the computation of the tax loss subject to the risk limitation only when it becomes deductible under the farming syndicate rules.

Effective dates

This provision applies to losses attributable to amounts paid or accrued in taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $52 million in fiscal year 1977, $40 million in fiscal year 1978, and $37 million in fiscal year 1981.

3. Farm Operations

a. Farming Syndicates (sec. 204 of the bill and secs. 278 and 464 of the Code)

Present law

Under present law, farm operations are governed by special tax rules, many of which confer tax benefits on farming activities and on persons who engaged in farming. Under present law, the special tax rules available to farmers can be utilized by both full-time farmers and by high-bracket taxpayers who participate in farming as a sideline. Part-time farmers are entitled to use the special farm rules even

[9] However, partnerhips engaged in two or more different activities, such as movies and equipment leasing, or movies and farming are to be treated as having that number of activities and the at risk limitation is determined separately for each activity.

if they are absentee owners who pay agents to operate their farming activities and regard their own participation (such as being limited partners in a nationwide syndicate) as a completely passive investment.

Taxpayers engaged in farming may report their income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Farmers may also deduct the cost of seeds and young plants purchased in one year which will be sold as farm products in a later year.[1] These rules contrast with the tax rules applicable to nonfarm taxpayers engaged in the business of selling products, who must report their income using the accrual method of accounting and must accumulate their production costs in inventory until the product is sold.

The special inventory exception for farmers was adopted by administrative regulation more than fifty years ago. The primary justification for this exception was the relative simplicity of the cash method of accounting which, for example, eliminates the need to identify specific costs incurred in raising particular animals.

The Treasury has also long permitted farmers to deduct currently many of the costs of raising or growing farm assets (such as costs related to breeding animals, orchards and vineyards) which are used in the trade or business of farming.[2] (In similar nonfarming businesses, such as manufacturing, these costs generally are treated as capital expenditures and are depreciated over their useful lives.) These assets are used in a taxpayer's business and may eventually be sold at a gain which is taxed at the lower capital gain tax rate. Since development costs can be deducted before the income is realized from the sale of livestock or crops, the development costs may offset a farm investor's income from other sources such as salaries, interest, professional fees, etc.

Certain other provisions of present law allow specific types of capital improvements to farmland to be deducted when the taxpayer pays them. These costs include soil or water conservation expenditures (sec. 175), fertilizer costs (sec. 180), and land clearing expenses (sec. 182). Similar capital expenditures in a nonfarm business would be added to the basis of the property and, since land is nondepreciable, could be recovered only out of the proceeds when the land is sold.

Capital gain treatment is generally available on the sale of depreciable assets used in farming (as well as on the sale of the underlying farmland itself), even though these assets or land may have been developed or improved by expenditures which were deducted against ordinary income.[3] In effect, a farm investor's income which is initially sheltered by accelerated farm deductions is transformed into added

[1] However, a farmer may not deduct the purchase price of livestock, such as cattle, which he intends to fatten for sale as beef.

[2] Not all costs relating to development of farm assets are currently deductible. A farmer is required to capitalize costs of water wells, irrigation pipes and ditches, reservoirs, dams, roads, trucks, farm machinery, land and buildings.

Section 278 of present law specifically requires capitalization of all amounts attributable to the planting, cultivating, maintaining or developing of an almond or citrus grove during the first four years after the grove was planted.

[3] Under section 1231, a taxpayer who sells property used in his trade or business obtains a special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the gain, if any, is treated as capital gain. The loss, if any, is treated as an ordinary loss. Machinery, equipment, buildings and land used by a taxpayer in his business are examples of section 1231 property.

capital value of the farm asset and taxed as part of that value when the farm capital assets (vineyard, breeding animal, farmland, etc.) are later sold.

After breeding animals, vineyards or orchards reach maturity and are held for the production of annual crops, farmers and farm investors continue to receive tax benefits through deductions for accelerated depreciation.[4]

Capital gain treatment on the sale of farm assets held for the production of income or used in a taxpayer's farm business is not available to the extent that various recapture rules of present law are applicable. For example, section 1251 requires a limited recapture as ordinary income (rather than capital gain) of previous farm tax losses whenever assets used in a farming business are sold or disposed of. (This section of present law is affected by section 203 of the committee amendment.)

Section 1252 recaptures amounts previously deducted as soil and water conservation and land clearing expenses if farmland is sold within 5 years after acquisition. If the land is held for a longer period, the amount recaptured is reduced by 20 percent for each year over 5 years that the property is held. Thus, if the land is held more than 10 years, no recapture is required on a sale of farmland.

The holding period for long-term capital gain treatment of cattle and horses held for draft, breeding, dairy, or sporting purposes (such as horse racing) is 24 months (sec. 1231(b) (3)). The minimum holding period for other livestock held for such purposes is 12 months. (One effect of this rule is that many sales of "culls" from a breeding herd, i.e., animals regarded as unsuitable, are taxable at ordinary income rates, since many culls are sold within 24 months.) [5]

Section 183 limits the current deduction of expenses in an activity which a taxpayer conducts other than "for profit." Although not limited to farming, this provision may affect a variety of farm operations. If an activity is found not to be engaged in for profit, expenses can be deducted only to the extent that income derived from the activity exceeds deductible interest, taxes and casualty losses.

Reasons for change

Farm investments offer an opportunity to defer taxes on nonfarm income where investors can take advantage of the special farm tax rules to deduct farm expenses in a year or years prior to the years when the revenue associated with such expenses is earned. This type of

[4] For example, an investor or rancher can use 200 percent declining balance depreciation on the purchase price of breeding animals which he originally purchased for the herd. If the rancher purchased cattle which had been used for breeding by a previous owner, the cattle can be depreciated on the 150 percent declining balance method.

The offspring of purchased animals cannot be depreciated, however, since the owner is considered to have no cost basis in such animals. (As indicated earlier, however, the cost of raising such offspring can be expensed.)

Accelerated depreciation under a 150-percent declining balance method is also available for new farm buildings and for the costs of purchased vineyards and orchards. The capitalized costs of vineyards and orchards planted by the taxpayer may be depreciated on a 200-percent declining balance method.

[5] The statute also prevents tax-free exchanges of livestock of different sexes (sec. 1031 (e)). Such exchanges had previously been used to enable a rancher (or ranch investor) to build up his herd free of current tax by exchanging bull calves, most of which are not used for breeding purposes, for female calves which could be used to increase the size of the herd.

deferral can occur regardless of whether the proceeds from the later sale of the underlying products are taxed at ordinary income or capital gain rates. Generally, in farming operations tax losses can be shown in early years of an investment because of (1) the opportunity to deduct, when paid, costs which in nonfarm businesses would be inventoried and deducted in a later year, (2) the ability to deduct, when paid, costs which should properly be capitalized, and (3) the ability to claim depreciation deductions which exceed straight-line depreciation.

These tax losses may offset income from a taxpayer's other nonfarm occupations or investments on which he would otherwise have to pay tax currently. When the income which is related to these deductions is reported, it will not be reduced by the amount of the deductions properly attributable to it (and will thus be greater in net amount than it otherwise would be). This lack of matching results in deferral of taxes from the years when the initial deductions were taken. If the related farm income is eventually realized as capital gain (as it may be where breeding animals or orchards are sold), conversion of ordinary income (against which the expenses were deducted) into capital gain may also result. Even without the possibility of conversion, however, the tax advantages of deferral alone are frequently sufficient to motivate many high-income taxpayers to engage in certain types of farming activities.

High-bracket taxpayers have continued to use farm tax rules to shelter nonfarm income because (except for citrus and almond groves) the restrictions in present law do not prevent the initial deferral of taxes on nonfarm income by means of accelerated deductions incurred in farm activities. Present law forcuses largely on recapturing some deductions which otherwise would be used to convert ordinary income into capital gain, and on denying capital gain treatment by increasing the holding periods for farm assets. However, under the cash method of accounting, farm expenses are still deductible as they are paid. The time value of deferring taxes on nonfarm income remains a strong attraction for outside investors to invest in farming and to use as much borrowed money as possible to create farm "tax losses."

Since 1969, in particular, the number and volume of publicly syndicated investments in almost all areas of agriculture have increased substantially. Farm tax benefits have been effectively packaged and sold to high-bracket taxpayers through limited partnerships (and management contracts) for investments in cattle feeding and breeding, tree crops, vegetable and other field crops, vineyards, dairy cows, fish, chickens, and egg production.

Table 1 sets forth the average farm loss reported for tax purposes since 1969 by individual taxpayers in different income brackets. This Table shows that average farm losses have increased as taxpayers' income levels have increased, and that this trend has remained consistent during the four years covered by the Table. The fact that the largest farm losses are concentrated in income levels over $100,000 suggests that high-bracket taxpayers have continued to make use of the special farm tax rules to shelter their nonfarm income.

TABLE 1.—NET FARM LOSSES BY SIZE OF ADJUSTED GROSS INCOME

Adjusted gross income	1970		1971		1972		1973	
	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss	Number of returns showing farm loss	Average farm loss
All returns—total	1, 234, 092	($2, 350)	1, 290, 203	($2, 540)	1, 171, 591	($2, 758)	1, 218, 962	($3, 343)
Total net farm loss (thousands)		(2, 899, 513)		(3, 277, 548)		(3, 230, 956)		(4, 074, 998)
Under $5,000	485, 531	(2, 659)	475, 983	(2, 969)	363, 492	(3, 281)	371, 489	(4, 323)
$5,000 under $10,000	379, 947	(1, 576)	385, 338	(1, 664)	325, 492	(1, 879)	290, 056	(2, 365)
$10,000 under $20,000	284, 652	(1, 669)	327, 808	(1, 822)	354, 754	(1, 852)	397, 588	(2, 123)
$20,000 under $50,000	63, 949	(4, 202)	78, 358	(4, 087)	100, 840	(3, 894)	126, 567	(3, 907)
$50,000 under $100,000	14, 697	(9, 473)	16, 575	(9, 527)	19, 642	(9, 607)	24, 494	(8, 970)
$100,000 under $500,000	5, 012	(21, 016)	5, 787	(20, 903)	6, 941	(21, 784)	8, 390	(23, 108)
$500,000 under $1,000,000	210	(43, 143)	252	(52, 516)	301	(50, 296)	268	(70, 451)
$1,000,000 or more	94	(128, 149)	102	(134, 069)	129	(170, 481)	110	(110, 018)

Source: U.S. Treasury Department, Statistics of Income—Individual Income Tax Returns, 1970, 1971, 1972, 1973 (preliminary).

Deferral shelters.—Some of the types of farming operations which are used as deferral shelters are as follows:

(a) *Cattle Feeding.*—Cattle feeding offers one of the best known and, until recent downturns in the farm economy, most widely used deferral shelters. Typically, the investment is organized as a limited partnership or as an agency relationship (under a management contract) in which a commercial feedlot or a promoter agrees to act as an agent for the investor in buying, feeding and managing cattle. After being fed a specialized diet for four to six months, the fattened cattle are sold at public auction to meat packers or food companies. A cattle feeding venture of this kind is typically formed in November or December, using leveraging and the cash method of accounting to permit taxpayers with income from other sources to defer taxes otherwise due on that income in that year by deducting expenses for prepaid feed, interest, and other costs incured in the feeding venture. Income is realized in the following year when the fattened cattle are sold. At that time, the bank loans are repaid and any unpaid fees due the feedlot (or promoter) are deducted. The balance is distributed to the investors. Since feeder cattle are held for sale to customers, sales of the animals produce ordinary income. If the investors were to reinvest their profit from one feeding cycle into another one, they could theoretically defer taxes indefinitely on the nonfarm income which they sheltered originally.

Since most investors in cattle feeding shelters buy in at the end of the calendar year, deductions for prepaid feed for the cattle have been central to the creation of tax losses in that year.[6]

(b) *Shell eggs.*—Another deferral shelter involves the production and sale of eggs. In egg shelters, almost the entire amount invested and borrowed can be spent on items for which deductions are claimed in the first year. These items include poultry flocks, prepaid feed, and (to some extent) management fees to the persons who operate the program for the investors. Under present law, amounts paid for egg-laying hens which are commonly kept for only one year from the time they start producing are allowable deductions in the year the poultry is purchased.[7]

Deferral and conversion shelters.—A deferral and conversion shelter offers an investor an opportunity both to defer taxes and also to convert ordinary income into capital gain. The manner in which these benefits are obtained is by deducting development costs of section 1231 property (breeding cattle, orchards, vineyards, etc.) and capital gain property (farmland) from ordinary nonfarm income and by later selling the developed assets after the investor has held them long enough to qualify for long-term capital gain rates. Since the recapture rules which apply to deducted development expenses (e.g., section 1251) are much more limited in scope than depreciation recapture rules gener-

[6] In recent years, the Internal Revenue Service has questioned deductions for prepaid feed claimed by taxpayers using the cash method of accounting. The Service (in Rev. Rul. 75-152) has prescribed several technical criteria and relied on its general authority to recompute a taxpayer's income if deductions materially distort his income. However, investors in cattle feeding shelters may, in some cases, still curcumvent the administrative criteria in order to justify deductions for prepaid feed.

[7] Rev. Rul. 60-191, 1960-1 C.B. 78. The purchase cost of this poultry may be deducted currently if the farmer consistently does so and if the deductions clearly reflect his income.

ally, many farm operations can be structured so that there will be little or no recapture of previously deducted development costs.

(a) *Livestock breeding.*—Livestock breeding offers taxpayers the opportunity to defer taxes over a period of two or more years and also to convert ordinary income into capital gain. In general, breeding operations rely on current deductions for prepaid expense items; current deductions for expenses of raising young animals to be used for breeding, dairy, draft or sporting purposes; the investment credit; accelerated depreciation and additional first-year depreciation on purchased animals and equipment; and capital gain when the mature animals are eventually sold.

Although cattle is the most widely used breeding shelter, there have also been investments offered for the purchase, breeding and sale of horses, fur-bearing animals (such as mink and chinchilla), other types of farm animals (such as hogs), and some kinds of fish and shellfish.

(b) *Orchards, groves, and vineyards.*—An investment in an orchard, vineyard or grove involves a "tree crop" as distinct from a "field" crop such as vegetables. The list of tree crop partnerships covers virtually anything grown in an orchard or vineyard in the form of trees or vines which produce annual crops of fruits (e.g., grapes, apples or avocados) or nuts (e.g., pecans, pistachios or walnuts).[8]

During the development period of trees or vines, the owners deduct costs of spraying, fertilizing, irrigating and generally cultivating the tree or vine to its crop-producing stage. They also depreciate farm machinery, irrigation equipment, sprinkler systems, wells and fences which they install on the property. They can also obtain the investment credit; and deductions may also be available for interest, fees and some prepaid items. After the trees start producing fruit or nuts, the owner can depreciate the costs of the seedlings and their original planting. (These costs were capitalized when incurred.) Such depreciation can partly shelter the annual crop income. Income from the crop sales is ordinary income. Capital gain is available, however, when the underlying land and the orchard are sold (except to the extent that recapture rules come into play).

Use of farming syndicates.—These special farm tax rules have been utilized not only by taxpayers who are actively engaged in farming enterprises with the intention of making a profit, but also by passive investors whose motivation, in large part, consists of a desire to use these farming rules to shelter income from other sources. These passive investors are frequently members of "farming syndicates" formed by a promoter or operator. In order to offer attribution of losses and limited liability to the investor, a farming syndicate is generally structured as either a limited partnership or as an agency relationship with a management contract (and with limited liability generally provided for by nonrecourse indebtedness, insurance, stop-loss guarantees, etc.). During the 5-1/2 years between January 1, 1970, and July 1, 1975, the dollar amount of tax shelter offerings in partnership form registered with the National Association of Securities Dealers was $942,424,000 in cattle feeding and breeding ventures and

[8] Citrus fruits and almonds are generally no longer suited to tax shelter because of the cost capitalization rule of section 278.

$166,575,625 in vineyards and other farming shelters. (There are many more private syndications which are not required to be registered.)

Summary.—The committee believes that the special farm tax rules should be continued for most farmers who are actively engaged in farm operations, but that such special farm tax rules should be severely curtailed for farming syndicates in which a substantial portion of the interest is held by taxpayers who are motivated, in very large part, by a desire to shelter other income, rather than by a desire to make a profit in the particular farming operation.

The committee believes that reducing tax incentives for high-bracket taxpayers who invest in syndicated farming operations will improve the competitive position of full-time farmers who must look to the income generated from farm operations for all or most of the return on their investment in farm operations.

The committee amendment differs very substantially from the House bill, which contained a series of complex provisions (referred to as a limitation on artificial losses, or LAL) designed to limit the current deduction of certain farm expenses and provisions requiring many farm corporations to use the accrual method of accounting (and to capitalize preproductive period expenses). The committee deleted these provisions because they seemed likely to affect many taxpayers who, in the committee's judgment, should be entitled to continue to use the cash method of accounting and the other farm tax rules. In addition, the committee believes that LAL as applied to farming is too complex and requires too much recordkeeping for many farmers who might be subject to the provisions, even taking into account the exceptions contained in the House bill. As a result, the committee has substituted, in lieu of the House provisions, rules dealing with farming syndicates to require certain expenses to be deducted when the purchased item is consumed or used, rather than when paid, and to capitalize other expenses.

Explanation of provision

The committee amendment requires farming syndicates to deduct expenses for feed, seed, fertilizer, etc. only when consumed, to deduct expenses of purchased poultry only over their useful life (or, in the case of inventory, only when disposed of) and to capitalize certain cultivation, maintenance, etc. expenses of groves, orchards and vineyards to the extent such expenses are incurred before the grove, orchard or vineyard becomes productive.[9]

Definition of farming syndicate.—For purposes of these provisions, a "farming syndicate" is defined as including (1) a partnership or other enterprise engaged in farming if, at any time, any interest in the partnership or other enterprise has been offered for sale in an offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale, (2) a partnership engaged in the trade or business of farming if more than 50 percent of the losses during any period are allocable to limited

[9] Also, as a general limitation on the use of the farm tax rules, the committee provided that tax losses attributable to certain deductions incurred in farming are to be allowable in any year only to the extent of the amounts for which the taxpayer is at risk in the business. This rule applies to all types of taxpayers engaged in any type of farming operation (sec. 202 of the committee amendment).

partners, and (3) any other enterprise engaged in farming if there is an allocation of more than 50 percent of the losses to persons with limited risk.[10]

The first and third categories include as farming syndicates many forms of organization of farm enterprises such as general partnerships, agency relationships created by management contracts, trusts, and interests in subchapter S corporations.[11] If an interest in any such enterprise has been offered for sale in an offering required to be registered, it is a farming syndicate. Similarly, unless excepted by the "active management" rules described below, if more than 50 percent of the losses during any year are allocable to persons with limited risk similar to limited partners, the enterprise will be treated as a farming syndicate.

An exception to the definition of "farming syndicate" is made for holdings attributable to active management.[12] This exception provides that, with respect to the rules that would make an enterprise a farming syndicate because of a more than 50 percent loss allocation to limited partners or other limited risk parties, loss allocations will not be treated as made to such partios where the person to whom a loss allocation is made had previously participated actively in the management of the enterprise's farming activity for a period of not less than five years even though such loss allocation would otherwise be treated as a loss allocation to a limited risk party. Also, a limited partnership interest or similar limited risk interest held by a member of a family of a person who has actively participated in the management of the farming operations will not be treated as a limited risk interest which would be taken into account in determining whether an enterprise is a farming syndicate. For purpose of this provision, the family of an individual includes not only his brothers and sisters (whether by whole or half-blood), his spouse, ancestors, and lineal descendants but also other lineal descendants of the individual's parents and grandparents.

This rule is designed to insure that the term "syndicate" does not include an enterprise in which a limited risk interest is held by a person who has actively participated in the management of the enterprise for not less than five years merely by reason of his holding such a limited risk interest. Also, a member of the family of such a person, such as one of his heirs, would not be treated as a limited partner or other limited risk party for purposes of making the farming enterprise a farming syndicate. Thus, for example if A, an individual who has owned and operated a farm for more than five years, wishes to retire and forms the AB limited partnership with B, an unrelated individual,

[10] The definition of a farming syndicate is intended to be broad enough to cover not only limited partnership and other tax shelter offerings required to be registered with the Securities and Exchange Commission or with a State securities or real estate office, but also offerings made through a dealer who is a member of the National Association of Securities Dealers, or sold through an intrastate broker-dealer or through a real estate company, even if not required (under securities laws) to be registered with securities officials.

[11] Corporations other than subchapter S corporations are not treated as farming syndicates since tax losses in such corporations can not be passed through to its shareholders.

[12] The determination whether a person actively participates in the operation or management of a farm depends upon the facts and circumstances. Factors which tend to indicate active participation include participation in the day-to-day decisions in the operation or management of the farm, actually working on the farm, living on the farm, and engaging in the hiring and discharging of employees as compared to only the farm manager. Factors which tend to indicate a passive person similar to a limited partner include lack of control of the management and operations of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, not owning the farm land in fee, and having limited liability for farm losses.

and more than 50 percent of the losses are allocated to A, the limited partner, the AB partnership will not be treated as a farming syndicate because A's interest is not treated as a limited partnership interest for purposes of determining whether losses are allocated to limited partners. Similarly, if A later dies and the partnership is continued by B and C, A's son, the BC partnership will not be treated as a farming syndicate.

The committee amendment is essentially the same as the approach taken by the House bill with respect to the definition of farming syndicates, except that the House bill included as a third category of farming syndicates, enterprises (other than limited partnerships) in which there is a 50 percent allocation of losses to passive persons. The committee is concerned that the definition of the third category of farming syndicates is too broad and will have an adverse impact on many legitimate farmers and ranchers. Accordingly, the committee amendment modifies the House bill to provide that, in defining this third category of farming syndicate, the focus is to be on the fact that a person or persons is involved whose liability is limited to his investment in the farm enterprise rather than the degree of active participation of the person (or persons) in the operation or management of the enterprise.

Thus, the committee believes that this third category of farming syñdicates should be limited to those farm enterprises in which a person (or persons) with limited risk is involved. If more than 50 percent of the losses during any year are allocable to such person or persons, the enterprise will be treated as a farming syndicate, unless excepted by the "active management" rules described above. Thus, the fact that an investor delegates authority to an agent or hires an independent contractor will not in itself render the investor subject to the farming syndicate rules unless there is limited risk. Moreover, except with respect to the specific exceptions for certain active management situations discussed above, it is not intended that the determination of whether an enterprise is a farming syndicate under this third category is to depend upon the degree of active participation in the management of the enterprise by the investor or whether the investor occupies a passive role in such enterprise.

In determining whether a person has "limited risk" all the facts and circumstances are to be taken into account. Generally, for purposes of this definition, a person will be considered to have limited risk if he is protected against loss to any significant degree by nonrecourse financing, stop-loss orders, guarantees, fixed price repurchase (or purchase) agreements, insurance, or other similar arrangements. A person with limited risk might include, in appropriate circumstances, (1) a general partner who has obtained a guaranty or other protection against loss from another general partner or an agent, and (2) a principal who has given authority, in fact, to another party to conduct his operations (such as an investor who agrees to allow a feedlot to manage feeder cattle which he has purchased) and who utilizes nonrecourse financing, stop-loss orders insurance, etc., to limit his risk.

Definition of farming.—For purposes of these farming syndicate rules, the term "farming" is defined broadly to mean cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of animals. Thus, for example, a syndicate engaged in the raising of fish, poultry, bees, dogs, flowers, vegetables, etc., as well as livestock is engaged in farming and, thus, is a farming syndicate.[13]

Deduction of prepaid items.—The committee amendment adds a new section (sec. 464(a)) to the code to provide, in general, that, in the case of farming syndicates deductions for amounts paid for feed, seed, fertilizer, or other siṁilar farm supplies are allowed only in the taxable year in which the feed, seed, fertilizer or other supplies are used or consumed. This provision prevents a farm syndicate from obtaining current deductions for prepaid feed, seed, fertilizer, etc., except in situations where the feed, seed, fertilizer, or other supplies are on hand at the close of the taxable year solely because the consumption of such items during the taxable year was prevented on account of fire, storm, flood, or other casualty, or on account of disease or drought.

Costs of poultry.—Under present law taxpayers engaged in farming may not deduct the cost of purchased livestock; rather, they must inventory the livestock held for sale and deduct the cost only upon disposition, and they must capitalize the cost of purchased livestock used in the trade or business (such as cattle held for breeding purposes) and depreciate them over their useful lives. However, this is not the case with respect to poultry. A ruling by the Internal Revenue Service (Rev. Rul. 60–191, 1960–1 C. B. 78) allows cash basis taxpayers to deduct when paid the costs of both poultry held for sale and poultry used in the trade or business. These deductions are allowable, in general, because the poultry purchased for resale has a relatively small cost, and the poultry purchased for use in the trade or business, such as laying hens, has a useful life of less than one year. Some syndicates, however, have taken advantage of these rules and, coupled with the present rules relating to prepaid feed, have utilized the deductions for poultry to create tax shelters.

A new provision in the committee amendment (sec. 464(b)) does not allow a farming syndicate to deduct when paid costs of acquiring poultry. Rather, it requires that the cost of poultry acquired for resale not be deducted until the poultry is sold or otherwise disposed of. Also, in the case of poultry acquired for use in the trade or business (such as laying hens) or acquired both for use in the trade or business and for later resale, the costs must be capitalized and (taking into account salvage value) deducted ratably on a monthly basis over the lesser of twelve months or their useful life in the trade or business.[14]

Capitalization of development costs of groves, orchards, and vineyards.—The committee amendment amends section 278 to provide that, in the case of a farming syndicate, any amount otherwise allowable as a deduction which is attributable to the planting, cultivation, maintenance, or development of a grove, orchard, or vineyard, and which

[13] This definition of farming is somewhat narrower than the definition of farming found in the LAL provisions of the House bill which defined farming as including operations involving the growing of trees other than fruit and nut trees. In part this narrower definition reflects the fact that the committee amendment imposes on a limited group of taxpayers (those who are members of farming syndicates) specific rules which relate only to treatment of prepaid items, costs of poultry, and preproductive period expenses of orchards, groves and vineyards.

[14] Since the only basis for deducting the cost of the laying hens currently is that they have an expected useful life of less than one year, the requirement that deductions be taken over the lesser of 1 year or the useful life should not result in the acceleration of such deductions.

is incurred prior to the taxable year in which the grove, orchard, or vineyard begins to produce crops in commercial quantities is required to be capitalized. Such expenditures can thereafter be recovered by depreciation of the grove, orchard, or vineyard. A limited exception to this capitalization rule is for amounts allowable as deductions (without regard to section 278) which are attributable to a grove, orchard, or vineyard, which is replanted after having been lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty.

Where these new rules apply to a situation in which section 278(a) (relating to capitalization of certain expenses of citrus and almond groves) requires capitalization but for a different period (4 years instead of the preproduction period), the rules of capitalization with respect to a farming syndicate are to govern. Similarly, if an amount is incurred as a cost of fertilizer, or other prepaid supplies, which is governed by the rules of new section 464(a), such amount is nonetheless subject to the farming syndicate capitalization rules of section 278(b). Thus, in such a case, no deduction would be allowed upon consumption of the fertilizer, but rather such amount would have to be charged to capital account.

There are no comparable provisions in the House bill, except that the House bill used the concept of farming syndicates in its LAL rules.

Effective dates

The new provisions relating to the timing of deductions for prepaid feed, seed, etc. and costs of poultry are to be effective for taxable years beginning after December 31, 1975. The rules requiring capitalization of certain costs of groves, orchards, or vineyards, apply to groves, orchards, or vineyards planted after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $74 million in fiscal year 1977, $31 million in fiscal year 1978, and $34 million in fiscal year 1981.

b. Limitation of Loss With Respect to Farms to the Amount for Which the Taxpayer Is at Risk (sec. 202 of the bill and sec. 465 of the Code)

Present law

Generally, the amount of depreciation or other deductions which a taxpayer is permitted to take in connection with a property is limited to the amount of his basis in the property. Likewise, in the case of a partnership, the amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, under present law, basis in a property may include nonrecourse indebtedness (i.e. a loan on which there is no personal liability) attributable to that property. Where a partnership incurs a debt obligation, and none of the partners has personal liability on the loan, all of the partners are treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e. each partner's share in the nonrecourse indebtedness is added to his basis in the partnership) (See regulations § 1.752–1(e)).

Also, there is generally no limitaiton on the amount of deductions that can be taken in situations where the taxpayer is protected against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement, insurance or otherwise.

Reasons for change

Taxpayers have combined the special farm tax rules (discussed under the farm syndicate section above) with nonrecourse indebtedness, and stop-loss orders, etc., to deduct losses in a taxable year which are substantially in excess of the maximum amount they could ultimately lose with respect to their investment in farming. Although some of these situations may be limited by the restrictions on deductions imposed on syndicates (as described above), some farming shelters may not involve syndicates. Also, the limitations on syndicates do not affect all types of farming operations. For instance, winter vegetables, rose bushes and other nursery plants are not restricted by the restrictions on farming syndicates, except to the extent that such syndicates utilize prepaid seed, fertilizer, and other farm supplies. (The utilization of such prepaid items is not necessary for the creation of substantial tax shelter in these types of operations.)

Explanation of provisions

To prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in farming operations, the committee amendment provides that the amount of any loss (otherwise allowable for the year under present law) which may be deducted in connection with a trade or business of farming, cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year.

For more detail as to the application and scope of the at risk rule, see section 1, above.

In the case of farming activities carried on by an individual, the "at risk" proposal applies separately to each farming activity. Whether a taxpayer is engaged in one or more farming activities depends on all the facts and circumstances of the case. Generally, some of the significant facts and circumstances in making a determination are the degree of organizational and economic interrelationship of various activities in which the taxpayer is engaged, the business purpose which is (or might be) served by carrying on the various activities separately or together, and the similarity of the various activities. Thus, for instance, if a rancher engaged in cattle raising on his own ranch also purchases cattle which he has placed in a commercial feedlot, he will generally be treated as being in two separate farming activities. However, if such a rancher were, as a consistent business practice, to take cattle raised on his own ranch and place them in a commercial feedlot, he might well be treated as engaged in only one farming activity.

All farming activities engaged in by a partnership or subchapter S corporation will be treated as one activity for purposes of applying this provision.[15]

The House bill also had an at risk provision which applied to certain farm operations. The committee amendment is broader than the House bill, however, because the former applies to all types of farming operations whereas the latter applies only to livestock operations

[15] This aggregation approach is adopted because of the difficulties of allocating a partner's at risk amount between different activities.

and certain crops. The applicability of this provision was broadened in order that this provision (rather than LAL, as in the House bill) serve as an overall limitation on the extent of tax benefits available to taxpayers engaged in farming.[16] Unlike the House bill, the committee amendment does not apply to corporations (although it does apply to shareholders of a subchapter S corporation). The committee made this change because corporations do not appear to utilize non-recourse indebtedness, stop-loss arrangements, etc. to obtain tax losses in excess of investment.

Effective date

In the case of farm operations, the at risk limitation applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975.

Revenue estimate

The revenue estimate for the "at risk" provision with respect to farming is included in section 1 above.

c. *Termination of Additions to Excess Deductions Accounts Under sec. 1251 (sec. 203 of te bill and sec. 1251 of the Code)*

Present law

Under present law (sec. 1251), individuals who report their farm operations on the cash method of accounting, and who have more than $50,000 of nonfarm adjusted gross income during a year, must maintain an "excess deductions account" (EDA) for a net farm loss sustained in the same year to the extent the loss exceeds $25,000. (It is immaterial what specific farm deductions produced the farm loss.) The EDA account is a cumulative account adjusted from year to year to take into account net farm income or loss. For the most part, when the farm assets used in the taxpayer's business (except depreciable real property) are sold or otherwise disposed of, the portion of the gain on the sale or other disposition equal to the balance in the excess deductions account must be reported as ordinary income, rather than capital gain. Any gain recaptured in this manner is then subtracted from the balance in the EDA account as of the end of the same taxable year.[17]

In the case of dispositions of farm land, present law (sec. 1252) requires recapture of deductions allowed for soil and water conservation expenditures (sec. 175) and for land clearing expenditures (sec. 182) on a gradually reducing scale depending on how long the land is held. However, if recapture is required as a result of an EDA account, this is to occur in the case of a gain or disposition even though the property is subject to a lesser recapture as a result of prior soil and water expenditures or prior land clearing expenditures.

[16] The committee amendment broadens the House bill's concept of the extent to which a taxpayer is at risk by generallv treating him as being at risk to the extent of the unrealized appreciation in assets which are used by a taxpayer if the nonrecourse indebtedness used to purchase or improve another property is secured by the appreciated property.

[17] Corporations (other than subchapter S corporations) and trusts must establish an EDA account for the full amount of their farm losses regardless of size and regardless of the amount of their nonfarm income. A Subchapter S corporation is governed by the same dollar limitations that apply to individuals, except that the corporation must include in its nonfarm income the largest amount of nonfarm income of any of its shareholders.

Reasons for change

Present law continues to allow a farm investor who uses the cash method of accounting to defer current taxes on his nonfarm income. It merely places a potential limit on the amount of ordinary nonfarm income which may be converted to capital gain in a future year. Thus, even where an EDA account must be maintained, this provision reduces the conversion of ordinary income into capital gain but does not affect the time value of deferring taxes on nonfarm income or on annual farm crop income.

The experience with this provision since it was enacted in 1969 also suggests that the dollar floors which must be reached before farm losses are subject to recapture are quite high, and that the application of the provision is very limited. Treasury statistics of income since 1969 show that the number of tax returns which show nonfarm income of $50,000 and higher and a net farm loss of $25,000 or more has generally been less than one percent of all returns which report both nonfarm income and farm losses. Treasury statistics also show that the provision affects no more than 8 percent of the dollar amount of all farm losses reported on returns which show both nonfarm income and farm losses. Furthermore, it appears that the provision is difficult to apply and susceptible of varying interpretations.

The committee has concluded that an approach which focuses solely on preventing conversion of ordinary nonfarm income to capital gain, without limiting the initial deferral of current taxes on nonfarm income, does not deal effectively with the use of farm tax rules by high income taxpayers to "shelter" nonfarm income, particularly in some of the more flagrant abuses of the farm tax rules in publicly syndicated farm tax shelters which are carefully structured to avoid or minimize the effects of section 1251.

Although the committee amendment differs from the House bill in its approach to farm tax shelters, the committee believes that its provisions limiting the deductions in the case of farm syndicates and providing at risk limitations to farm operations generally deals more directly with farm shelter problems without the complexity of the LAL provisions as provided in the House bill.

Since the new limitations will in many cases, prevent the deferral of taxes on nonfarm income, it does not appear desirable to continue a complex rule of limited applicability in the statute which recaptures income previously offset by certain farm losses.

Explanation of provision

The committee amendment limits the future applicabily of the present EDA provision (sec. 1251) by providing that no additions to an excess deductions account need be made for net farm losses sustained in any taxable year beginning after December 31, 1975. Farm losses incurred during any such taxable year or years will instead be governed by other limitations under the committee amendment.

If property which is "farm recapture property" (within the meaning of section 1251(e)(1)) is disposed of during a taxable year beginning after December 31, 1975, however, the recapture rules of present law will continue to apply, but only with respect to EDA accounts required to be maintained for one or more years beginning before December 31, 1975.

This provision is the same as that in the House bill.

Effective date

The amendment to this provision will not affect any recapture of farm losses by reason of a disposition of farm recapture property during a year beginning on or before December 31, 1975.

In the case of dispositions of farm land, the termination of the provision described here for farm losses incurred in taxable years beginning after December 31, 1975, will mean that deductions taken under sections 175 and 182 in years beginning after December 31, 1975, will continue to be subject to recapture, but only to the extent required by section 1252. In such cases, section 1251 will cease to apply to any deductions under sections 175 and 182.

Revenue estimate

It is estimated that this provision will result in a decrease in tax liability of less than $5 million annually.

d. Scope of Waiver of Statute of Limitations in Case of Activities Not Engaged in for Profit (sec. 211 of the bill and sec. 183(e) of the Code)

Present law

Present law distinguishes between activities engaged in "for profit" and activities which are not engaged in for profit (sec. 183). In the case of an activity engaged in for profit, a taxpayer may deduct all expenses attributable to the activity even though they exceed the income from the activity. In the case of an activity not engaged in for profit, a taxpayer can deduct the allowable expenses attributable to the activity only to the extent that income derived from the activity exceeds amounts allowable for interest, taxes and casualty losses attributable to the activity. A taxpayer thus cannot utilize an operating loss incurred in an activity of this kind to offset his other income. Activities which raise issues of this kind include horse breeding, cattle breeding, the racing or showing of horses, and vacation homes.

In determining whether an activity is engaged in for profit, the facts and circumstances must be examined to determine whether the taxpayer entered the activity and continued it with the objective of making a profit. However, present law contains a provision under which an activity is presumed to be engaged in for profit if the activity shows a profit in at least 2 out of 5 consecutive taxable years ending with the taxable year in question. (In the case of raising, breeding, training or showing horses, the requirement is a profit in at least 2 of 7 consecutive years.)

If, at the end of a given year, the taxpayer has not conducted the activity for 5 (or 7) years, a special provision allows the taxpayer to elect to postpone a determination as to whether he can benefit by this presumption until he has conducted the activity for 5 (or 7) years (sec. 183(e)). This election was added to the Code in 1971. The committee reports at that time express an intent that a taxpayer who makes the election should be required to waive the statute of limitations for the 5 (or 7) year period and for a reasonable time thereafter. The aim was to prevent the statute of limitations (3 years, in the usual case) from running on any year in the period. The taxpayer, it was believed, should have time to claim a refund of tax paid by him during the period and the Internal Revenue Service should also have time to assess any deficiency owed by the taxpayer for any year in the period.

In carrying out this legislative intent, the Service has issued temporary regulations which require that a taxpayer who makes an election under section 183(e) must agree to extend the statute of limitations for each taxable year in the 5 (or 7) year period to at least 18 months after the due date of his return for the last year in the period. Such an extension must apply to all potential income tax liabilities arising during the period, including issues unrelated to deductions subject to tion 183 issues.

The reason for requiring such a broad waiver stems from 'a provision under current law which, in certain circumstances, allows only one notice of deficiency to be sent to a taxpayer with respect to a taxable year. If a taxpayer receives a notice of deficiency and then files a petition with the Tax Court relating to that notice, the Service cannot (as a general rule) determine an additional deficiency for the same taxable year (sec. 6212(c)). Therefore, if, within the present limitations period, the Service sends a deficiency notice to a taxpayer relating to an issue other than section 183 and the taxpayer petitions the Tax Court as to one or more of those issues, the Service cannot later assess a separate deficiency under section 183. In order to prevent such a result, the temporary regulations require the waiver to cover all tax issues during the presumption period and not just the potential section 183 issues.

Reasons for change

The requirement that all items on a taxpayer's returns for the early years of a 5 (or 7) year period be kept open creates several problems. The taxpayer must retain all records for those years for a substantially longer period of time than otherwise would be the case. Leaving the statute of limitations open for the entire return because of an item which may well be relatively minor is also contrary to the policy of prompt resolution of tax disputes. A taxpayer may also want a prompt resolution of other items on his return in order to limit his potential interest cost as to any deficiency arising from items not related to the section 183 issues on his return.

In order to accomplish the purposes which Congress sought when it enacted the look-forward presumption of section 183(e), it is not necessary to keep the statute of limitations open for all issues on the taxpayer's return during the 5 (or 7) year period. The only issues on which the statute of limitations needs to remain open concern the deductions which will be tested as to whether they are incurred in an activity which the taxpayer engaged in for profit. The committee believes that a taxpayer should be able to take full advantage of a statutory presumption which was intended for his benefit, without unnecessarily extending the statute of limitations for items on his return which are unrelated to deductions which might be disallowed under section 183.

Explanation of provision

The committee amendment revises present law (sec. 183(e)) to provide that if a taxpayer elects to postpone the determination of his conduct of an activity under the presumption provisions, the statutory period for the assessment of any deficiency specifically attributable to that activity during any year in the 5 (or 7) year period shall not expire until at least two years after the due date of the taxpayer's income tax return for his last taxable year in the period. This provision is the same as that in the House bill.

If a taxpayer makes an election under section 183(e) of present law and postpones a determination whether he engaged in a particular activity for profit, the making of this election automatically extends the statute of limitations, but only with regard to deductions which might be disallowed under section 183. The taxpayer would not have to agree to extend the statute of limitations for any other item on his return during the 5 (or 7) year period. On the other hand, even if the taxpayer has petitioned the Tax Court with regard to an unrelated issue on his return for any year in the same period, the Service will be able to issue a second notice of deficiency relating to a section 183 issue as to any taxable year in the period.

In order to assure the Service adequate time to reexamine the section 183 issue after the suspension period has ended, this new provision allows the Service two years after the end of the period in which to contest the taxpayer's deductions. The making of the election extends the statute of limitations on any year in the suspension period to at least two years after the due date of his return for the last year in the period.[18] (The due date is to be determined without regard to extensions of time to file his return for the last year.)

The taxpayer's limited waiver of the statute of limitations would include not only the section 183 issue itself but also related deductions, etc., which depend on adjusted gross income and which might be affected if the deductions are disallowed in accord with section 183.

The provision for this limited waiver is not intended to affect the scope or duration of any general waivers of the statute of limitations which taxpayers have signed (or sign) before the date of enactment of this bill.[19]

Similarly, the bill does not affect general waivers of the statute of limitations which may be signed after enactment, since in order to

[18] (The bill does not shorten the usual 3-year statute of limitations as to any taxable year in the 5 (or 7) year period. Rather, it requires that the normal limitations period be extended as to any year in the 5 (or 7) year period as to which the normal 3-year limitation period would otherwise expire while the potential section 183 issues are held in suspense.

[19] The provision is not designed to affect existing general waivers of the statute of limitations, because to do so would allow taxpayers who have previously signed such waivers to escape an examination of issues not related to section 183 even though the Internal Revenue Service had attempted to make a timely audit of them. Thus, for example if, before the date of enactment of this bill, in examining a taxpayer's income tax return for 1970, a revenue agent had proposed adjustments to a taxpayers' allegedly unsubstantiated charitable contributions and to his horse breeding activities, and if the taxpayer made an election under section 183(e), and signed a general waiver of the statute of limitations until October 15, 1978 (i.e., until 18 months after the due date of his 1976 return), the agent could issue the taxpayer a deficiency notice for both items at any time prior to that date. After that date, however, the statute of limitations would continue to be open for issues relating to horse breeding activities conducted in 1970 until April 15, 1979, but would be closed for issues relating to the proper substantiation of charitable contributions after October 15, 1978.

avoid two controversies relating to overall income tax liability for the same year, a taxpayer may wish to postpone a resolution of nonsection 183 issues until the information relating to the section 183 presumption is available.

Effective date

This provision generally applies to taxable years beginning after December 31, 1969. However, it will not permit a reopening of the statute of limitations for any taxable year ending before the date of enactment of the bill and as to which the statute of limitations has expired before such date of enactment. Further, since this provision does not limit general waivers of the statute of limitations, a taxpayer who has previously signed a general waiver will not be able to take advantage of this new provision (and to argue that the statute of limitations has run on issues unrelated to section 183) until his general waiver expires.

Revenue effect

This provision is not expected to have any revenue effect.

4. Oil and Gas

a. Limitation of Loss to Amount at Risk (see (sec. 202 of the bill and sec. 465 of the Code)

Present law

Under present law, an owner of an operating interest in an oil or gas well is allowed the option (under sec. 263(c)) to deduct as a current expense the intangible drilling and development costs connected with that well. Intangible drilling costs include amounts paid for labor, fuel, repairs, hauling and supplies which are used in drilling oil or gas wells, clearing of ground in preparation for drilling, and the intangible costs of constructing derricks, tanks, pipelines and other structures and equipment necessary for the drilling of the wells and the preparation of the wells for production. But for the statutory election to deduct these costs currently, they would, in the case of a successful well, be added to the taxpayer's basis and recovered through depletion and depreciation; in the case of a dry hole, the intangible costs would be deducted at the time the dry hole is completed.

In the case of an oil and gas drilling venture, which is most often a limited partnership, the Service has ruled (in Rev. Rul. 68-139, 1968-1 C.B. 311) that a limited partnership may earmark a limited partner's contribution to expenditures for intangible drilling costs, thereby allowing the allocation of the entire deduction to the limited partners (if the principal purpose of such allocation is not the avoidance of Federal taxes).

The Service has also ruled (Rev. Rul. 71-252, 1971-1 C.B. 146) that a deduction may be claimed for intangible drilling costs in the year paid, even though the drilling is performed during the following year, so long as such payments are required to be made in the first year under the drilling contract in question.

Generally, the amount of losses which a taxpayer is permitted to take in connection with a business or investment in an oil or gas property is limited to the amount of his basis in the property. In the case of a partnership investing in oil and gas properties, the amount of losses a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, under present law, basis in a property may include nonrecourse indebtedness (i.e., a loan on which there is no personal liability) attributable to that property, and where a partnership incurs a debt and none of the partners have personal liability on the loan, then all of the partners are treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e., each partner's share in the nonrecourse indebtedness is added to his basis in the partnership).

Reasons for change

The use of leverage through nonrecourse loans in an oil or gas drilling fund expands the tax shelter potential of these investments to the extent that the leveraged amounts are used for intangible drilling and development costs. In these cases, investors can deduct amounts to produce losses sufficiently in excess of their cash investment so that the tax savings in the year of investment can exceed the amount invested. For example, an investor contributing $100,000 to a partnership for a 10 percent profits interest could have added to his basis another $100,000 if the partnership obtained a nonrecourse loan for $1,000,000. If all of the partnership's capital ($2,000,000) were spent on drilling costs and the partnership had no income, the investor could deduct all of his share of those costs, or $200,000. If the investor were in the 70 percent tax bracket, that deduction would reduce his taxes in that year by $140,000, or $40,000 more than his investment.

This leveraging of investments to produce tax savings in excess of amounts invested substantially alters the economic substance of the investment and distorts the working of the investment markets. Taxpayers can be led into investments which are otherwise economically unsound and which constitute an unproductive use of the taxpayer's investment funds.

Explanation of provisions

To prevent a taxpayer from deducting a loss in excess of his economic investment in an oil or gas property, the committee amendment provides that the amount of any loss incurred in connection with an oil or gas property may not exceed the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year. The detailed revisions of the at risk rule have been discussed above.

For purposes of the 65 percent of net income limitation (under section 613A(d)), and the 50 percent of income from the property limitation (under section 613(a)), the deduction for intangible drilling and development costs is to be taken into account without regard to the at risk provision (i.e., on the assumption that the intangible drilling and development costs are fully deductible).

For purposes of these rules, the at-risk provision is to be applied on a property-by-property basis (as defined for purposes of computing depletion under section 614). Where a parnership holds interests in several mineral properties, a partner's equity investment in the partnership is to be allocated among the various properties in accordance with regulations.

As discussed above, where the taxpayer has no personal liability with respect to a loan, he is to be considered at risk with respect to any indebtedness where the loan is secured by the taxpayer's personal or partnership assets which have an established value, to the extent of the value of the assets (net of any other nonrecourse indebtedness secured by these same assets). In the case of oil and gas wells a property is not considered to have an established value unless sufficient drilling has taken place to establish proven reserves on the property.

Effective date

This amendment is to apply to losses attributable to amounts paid or incurred with respect to oil and gas properties after December 31, 1975, in taxable years ending after that date.

Revenue effect

This provision will increase budget receipts by $45 million in fiscal year 1977, $18 million in fiscal year 1978, and $6 million in fiscal year 1981.

b. Gain from Disposition of Oil and Gas Property

The House bill provided that gain from the sale of oil and gas wells would be treated as ordinary income rather than capital gain to the extent that accelerated intangible drilling deductions had been taken with respect to those wells.

The committee deleted this provision because it felt that this recapture provision would significantly reduce the incentive for oil and gas drilling at a time when the nation desperately needs to increase production of oil and gas.

5. Motion Picture Films

a. At Risk Rule and Capitalization of Production Costs (secs. 202 and 207 of the bill and secs. 465–470 of the Code)

Present law

Motion picture shelters generally have two basic forms. In one format, a limited partnership is formed to purchase the rights to an already completed film. The purchase price is heavily leveraged (and often unrealistically inflated) and the partners claim substantial depreciation deductions. The principal features of the shelter are deferral and leverage. This format is sometimes referred to as a "negative pick-up" or "amortization purchase" transaction.

In the second type of format, the limited partnership is formed to produce a film (rather than to buy a completed film). The partnership enters into an agreement with a studio, with a distributor or with an independent producer to produce a particular film. The partnership uses the cash method of accounting and writes off the costs of production as they are paid. Typically the partnership is heavily leveraged and significant costs are paid with borrowed funds. The principal elements of this form of motion picture shelter are also deferral and leverage. The partnership in this type of shelter is sometimes referred to as a "service company" or "production company."

Another variation of this shelter is the film distribution partnership. In this shelter, the partnership also does not own an interest in the film, but obligates itself to distribute the film. By writing off the costs of distribution, the deferral occurs for the partners because the partnership's income from its distribution services is not realized until later years.

The basic principles of partnership tax law which benefit the motion picture tax shelter (and other shelters as well) include the use of the partnership form to allow limited partners to take into income their distributive share of the partnership's income or losses (which are generally determined under the partnership agreement). Also, the amount of partnership loss which the partner may deduct includes not only his own equity contributions to the partnership, but also his share of any nonrecourse debt which the partnership has incurred (see regulations § 1.752–1(e)). There are several aspects of present law, however, which relate particularly to motion picture shelters.

(*1*) *Film purchase shelter*

The income forecast method.—Motion pictures are usually depreciated on the "income forecast" method. (Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62.) This method is used because, unlike most other depreciable assets, the useful life of a motion picture is difficult to ascertain. Under the income forecast method, the taxpayer computes depreciation by using a fraction, the numerator of which is the income received from the film during the year and the denominator of which is the total estimated income which the film is expected to generate over its remaining lifetime. This fraction is then multiplied by the cost of the film. For example, if the taxpayer has a basis of $500,000 in his interest in the film, the income from the film through the end of the first year is $750,000, and the total estimated income from the film over its lifetime is $1,000,000, the taxpayer would be allowed to depreciate 75 percent of his basis, or $375,000. (If the income forecast increases or decreases as a result of changed circumstances, this change is taken into account for later periods. Thus, in the second year, depreciation under the income forecast method might be based on an income forecast denominator which was more or less than the amount used for the first year.)

The film purchase transaction works as a tax shelter only where the purchase price of the film (including nonrecourse indebtedness) exceeds its economic value.[1]

However, there is a substantial question under present law whether taxpayers in a film-purchase shelter are legally entitled to claim depreciation based on nonrecourse indebtedness where the "purchase price" of the film is in excess of the income forecast on the film.

[1] Assume, for example, that a limited partnership pays $1,000,000 for a film (consisting of $200,000 in cash and a 10-year nonrecourse note for $800,000). After the film is released, it becomes apparent that the film may not be successful and an income forecast of $200,000 is made for the film. Assuming $160,000 of this revenue (or 80 percent of the predicted total) were realized in the first year, the partners would depreciate 80 percent of their basis in the film, or $800,000 for a net tax loss (after taking account of the $160,000 of income from the film) of $640,000.

On the other hand, where the income stream is equal to or greater than the purchase price there is no shelter. For example, if the film is purchased for $2 million (and has this as its basis), but has an estimated income stream of $4 million, $3 million of which is earned during the first year, the result would be as follows. The partners would be allowed to take 75 percent of their $2 million basis as depreciation in the first year under the income forecast method (or a $1,500,000 deduction). However, the film would be also generating $3 million of income which the partners would have to recognize. Thus, the net tax effect would be positive taxable income to the partners of $1,500,000. Where the purchase price of the film and its estimated income stream are exactly equal, the depreciation deduction and the amount of income from the film should exactly offset each other.

While the authorities in this area have not been uniform, there are several cases which have disallowed the depreciation deduction based on nonrecourse liability where there was no substantial prospect that this liability would be discharged. In *Leonard Marcus*, 30 T.C.M. 1263 (1971), the court held that where the taxpayer purchased two bowling alleys for a 5 percent down payment, with a 20-year nonrecourse note for the balance, the taxpayer could depreciate only the basis represented by his down payment, and that the note could be taken into account for purposes of increasing the taxpayer's basis only to the extent that payments were actually made. The court held that the liability represented by the note was too contingent to be included in basis until payments were made.[2]

In *Marvin M. May*, 31 T.C.M. 279 (1972), the Tax Court held that a transaction in which the taxpayer purchased 13 television episodes for $35,000, and obligated himself to pay an additional $330,000 on a nonresource basis was a sham, because this amount was far in excess of the fair market value of the films and there was no realistic prospect (or intention) that the debt would ever be paid. Therefore the court disallowed the depreciation deduction claimed with respect to the film. See also Rev. Rul. 69–77, 1969–1 C.B. 59.[3]

It would seem that some of these same principles could often be applied in the case of a film purchase shelter, where the purchase price of the film consists largely of nonrecourse indebtedness and substantially exceeds the film's income forecast.

Depreciation recapture.—There is some question as to whether a movie film in the hands of a limited partnership, such as those described here, constitutes a capital asset (within the meaning of sec. 1221), or "property used in the trade or business" of the taxpayer which is neither "inventory," nor "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (within the meaning of sec. 1231).

If the film is not a capital asset (or section 1231 property), any income received with respect to the film would be ordinary income. Assuming that the film is found to be a capital asset, income realized on the sale or exchange of the film would be subject to the depreciation recapture rules of section 1245. Thus, the proceeds of the sale in excess of the taxpayer's adjusted basis would constitute ordinary income to the extent of any depreciation previously allowable with respect to the film.[4]

Even if the film is not sold, there should eventually be recapture of the depreciation attributable to the unpaid balance of a nonrecourse note which entered into the depreciable basis of the film. If the film is successful and the loan is repaid out of the partnership income, each partner must take into income his distributive share of the amounts

[2] In *Marcus,* the 20-year term of the note was substantially in excess of the useful life of the bowling alleys.

[3] As indicated above, under the partnership provisions, the partner may add to his basis in the partnership his share of the nonrecourse liabilities. However, section 752(c) provides that "a liability to which property is subject" shall be considered as a liability of the owner of the property "to the extent of the fair market value of such property . . ." Since the "fair market value" of a movie film ordinarily will not exceed of its total projected lifetime earnings, this suggests that a partner's basis cannot include his share of nonrecourse indebtedness to the extent that this indebtedness (plus the partner's down payment) exceeds the income forecast for the film.

[4] If the partner sold his interest in the partnership, the depreciation would be recaptured as an "unrealized receivable" under section 751.

used for repayment; the partner's basis would not be affected. (The partner's basis would increase to the extent that his distributive share of the partnership income was used for partnership purposes, such as repayment of the loan, but his basis would decrease in an equal amount because his share of the nonrecourse partnership liability was being reduced by the repayment.) If the film is not successful and the nonrecourse debt becomes worthless, a default, foreclosure or abandonment of the debt generally constitutes income to the partnership because such events are treated as a "sale" of the movie film, which is subject to the recapture rules of section 1245.[5]

(2) Production company shelter

Cash method of accounting.—Obtaining tax deferral through a production company transaction depends on whether the partnership can properly deduct its costs of producing the film as it pays them. This in turn depends on whether proper tax accounting practices permit the partnership to treat these costs as an item of expense or require the partnership to capitalize these expenditures and amortize them over the life of the asset. (In this case, the asset is the partnership's rights under the contract with the distributor-owner of the film.)

Under present law, a taxpayer is generally permitted to select his own method of accounting (sec. 446(a)) unless the method selected "does not clearly reflect income" (sec. 446(b)). If it does not, the law permits the IRS to compute the taxpayer's income in a way that will clearly reflect his income.

One problem with the motion picture service partnership's use of the cash method is the possibility that a particular partnership is really engaged in a joint venture with the distributor or with an independent producer, i.e., the investors provide financing and the studio/distributor or producer supplies personnel, production skills and also loan guarantees. As part owners of the film, the partnership would then have to capitalize its production costs.[6]

In such circumstances the question is whether failure to capitalize the expenses of producing the film (and thus, of the partnership's rights under the contract) results in a material distortion of income. There is a strong argument under present law that a material distortion of income does occur under these circumstances. See *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974), holding that "accepted accounting practice" and "established tax principles" require the capitalization of the cost of acquiring a capital asset, including costs, such as depreciation on equipment, which would generally be deductible if they were not allocable to the construction of the asset. (The production company's contract rights are not a capital asset, but these rights are an asset

[5] Likewise, if the partnership discontinues its operations, this should constitute a constructive distribution of the partnership assets (including, for this purpose, the unpaid portion of the nonrecourse note) to the partners, which in turn triggers the recapture rules of section 1245.

[6] In some cases, the personnel hired by the partnership to make the film are not in reality the investors' own employees but are supplied by the studio/distributor. In other cases, the investors' partnership subcontracts actual production work to the studio/distributor (or to its agents). Factors such as these, along with the sharing of profits and risks of loss, the distributor's day-to-day involvement in production and budget changes, etc., may tend to support treatment of the partnership as a joint venture.

Still another difficult question under present law for the motion picture "service company" is whether the partnership is conducting a trade or business if it makes only one picture or does not operate with regularity.

with a long useful life, so there is a strong argument that the capitalization principle should apply.)

On the other hand, there is one case relied on heavily by the investors in movie production partnerships which held that a building contractor's income was not distorted where the company constructed apartments and shopping centers under long-term construction contracts and deducted its costs on the cash method, while receiving payments over a five-year period after each project was completed. *C. A. Hunt Engineering Co.*, 15 T.C.M. 1269 (1956). Production company investors have argued that the same result should be allowed in their situation.

A related question under present law is whether a limited partnership producing a motion picture is engaged in selling or delivering a product (the film) and is therefore required to maintain an inventory. If this were the case, the labor costs paid in producing the inventory could not be deducted until the inventory item was sold. The argument against that view is that the production company is selling services (i.e. production services) rather than a product.

Another question under present law is whether the funds supplied by the limited partners are merely part of a financing transaction in which the investors are basically only loaning money to the distributor or other party who will own the completed film. As creditors, the financing parties would not be entitled to tax deductions for the amounts which they are lending.

(*3*) *IRS rulings position*

The Service has issued several revenue rulings with respect to the use of limited partnerships and nonrecourse loans.[7] Although these rulings have applicability outside the area of movie shelters, they also impose some limitations, at least in so far as the position of the Service is concerned, which apply both to the film purchase type transaction, and the production company arrangement.

These rulings suggest that many forms of nonrecourse loans may, in substance, be equity investments by the lender, which cannot be used by the limited partners to increase their bases in the film or in a production partnership. Purchase money loans by the seller of a film (in a negative pickup transaction) might be included in this category. The logic of these rulings might well apply also to the case where a loan is made to the investors' partnership by a bank, but is guaranteed by the studio which is selling the film (or for whom the film is being made, in the case of the production company shelter).

Reasons for change

The two formats commonly employed in connection with movie films, the film purchase shelter and the production company shelter, have the same basic elements, i.e., tax deferral and the use of leverage. In the case of the film purchase shelter, deferral occurs because of the rapid depreciation which is allowed in connection with movie films, and which is passed through to the limited partners, particularly in cases where the film is not economically successful. In the case of the pro-

[7] Rev. Proc. 74-17, 1974-1 C.B. 438; Rev. Rul. 72-135, 1972-1 C.B. 200; Rev. Rul. 72-350, 1972-2 C.B. 394.

duction company, the mismatching of expenses and income occurs because the partnership deducts the full cost of producing the film before the film is released and because the contract which the limited partnership enters with the "owner" of the film (usually a studio-distributor) often provides that payments to the production company for its "services" will be spread over a relatively long time period.

Both types of investments involve the use of leverage (i.e., nonrecourse loans) which allow the limited partners to receive tax deductions for amounts in excess of their economic investment. This result distorts the economic substance of the transaction by permitting the taxpayer to deduct money which he has neither lost nor placed at risk. In the case of movie shelters, the use of very heavy leverage factors is not uncommon.

As indicated above, questions exist under present law as to whether investors in certain cases are entitled to the deductions they are claiming in connection with movie shelters. Thus, many participants in these shelters may be claiming deductions which will later be disallowed by the Service.[8]

In addition, the committee has been informed that the production company shelter may be expanding into other areas, such as the publishing field.

For these reasons, under the committee amendment, the film purchase shelter is to be subject to an at risk rule, to prevent taxpayers from writing off more than their economic investment in this type of transaction. In the case of the production company shelter, the committee amendment requires capitalization of the expenses of production, not only for movies, but also for similar types of service company shelters. In addition, the production company movie shelter is to be subject to a modified at risk rule.

The House bill applied the "at risk" rule in the case of the film purchase shelter, the production company shelter and also applied the limitation on artificial losses (LAL) provision to both the film purchase shelter and the production company shelter in an attempt to limit the deductions available to the amount of income earned in the year. The committee believes that the treatment provided in its amendment with respect to film purchase shelters and production service company shelters (including the use of a service company to produce books, recordings and similar property as well as films) deals directly with the problems involved in these shelters and that it is not necessary to apply LAL.

Explanation of provision

The "at risk" rule

Under the committee amendment, as indicated above, both the film purchase shelter and the production company shelter are to be subject to the risk limitation. The provisions of the at risk rule have already been explained in detail in section 1 above.

[8] In the case of the film purchase shelter, the principal issue in potential abuse situations is whether the taxpayers have used an inflated basis for purposes of depreciation. In the case of the production company, the issue is whether the partnership has failed to reflect income properly by not capitalizing the production costs of the film. In both shelters, the use of leverage to increase the partners' bases might be subject to question, at least under certain facts and circumstances.

In the case of movie films, each film in which the taxpayer has an ownership interest, and each film which the taxpayer produces, displays or distributes, is to be considered a separate activity for purposes of the at risk rule.

In the case of a production company shelter, however (where there is no ownership interest in the film and the losses result from expenses of producing the film, rather than depreciation of a possibly inflated purchase price), the committee amendment provides an exception to the at risk limitation where three conditions are met. First of all, the investor must make a direct equity investment equal to at least 25 percent of his share of the film's total production costs. Thus, not more than 75 percent of the financing of the film may be on a nonrecourse basis, and no investor's interest in the activity may be leveraged at more than a three to one ratio.

Second, to come under this exception to the at risk limitation, the taxpayer must make an irrevocable election (in a time and manner to be prescribed in regulations, but not later than the due date for filing the return for the year in which the investment in the production company is made by the taxpayer) to treat his share of any nonrecourse indebtedness as having been discharged not more than five years after the first showing of the film, regardless of whether the indebtedness is actually discharged at that time. The purpose of this rule is to require the taxpayer to recognize income from the discharge of indebtedness at that time, and place a limitation on the period of tax deferral. Of course, if the taxpayer's share of the nonrecourse indebtedness is discharged, in whole or in part, before the expiration of the 5-year period, the taxpayer would recognize income at the time the indebtedness is actually discharged. (Also, if the taxpayer should fail to maintain his 25 percent equity interest in the film activity throughout the 5 year period, the election is to be terminated as of the date when the equity investment falls below 25 percent, resulting in recognition of income with respect to any outstanding nonrecourse indebtedness at that time.)

In addition, to assure that this exception is only available in cases where the film is primarily produced in the United States, the committee amendment provides that at least 80 percent of the direct production costs of the film must be paid or incurred in the United States. For purposes of this rule, the same test is to apply as is used, under the committee amendment, in determining whether a film is 80 percent U.S. produced for purposes of the investment credit for movie films.

Amortization of production costs of motion pictures, books, records, and other similar property

To prevent a situation where a taxpayer may attempt to accelerate his deductions in connection with the production costs of a motion picture film, thus producing a mis-matching of income and expenses attributable to the income, the committee amendment provides that a taxpayer is to be required to capitalize his share of the production costs and deduct them over the life of the income stream generated from the production activity. This rule is to apply to persons (other than nonsubchapter.S corporations) engaged in the service of producing, displaying, or distributing a film, sound recording (including discs, records, tapes, etc.) book, or similar property (such as a play, etc.).

Generally, it is anticipated that taxpayers who are subject to this capitalization requirement will (in effect) depreciate their capitalized expenses (in accordance with regulations to be prescribed by the Secretary) under a method analogous to the income forecast method. Thus, the production costs will be written off by the taxpayer over the useful life of the asset which he has acquired as a result of his investment. In the case of a service company shelter, the asset will be the taxpayer's contract rights under his contract with the motion picture distributor, publisher, etc.

For purposes of these rules, the numerator of the income forecast fraction will be the income which the tarpayer has received under the contract. The denominator of the fraction is to be the total income which the taxpayer may reasonably expect to receive under the contract. Thus, in the case of a film service partnership, for example, the denominator of the fraction is to include the partnership's share of any anticipated income from the film (where the partnership is compensated by a percentage of income from the film), as well as any guaranteed payments which the partnership is to receive under the contract, and any income from the discharge of indebtedness. Of course each item of anticipated income is to be taken into account only once; thus, where a partnership is entitled to 10 percent of gross income from the film, with a guaranteed payment of $1 million, the denominator of the income forecast fraction would be the greater of (1) 10 percent of the anticipated gross revenues from the film, or (2) $1 million (so as to avoid double counting).

In the case of a film production company which satisfies the requirements (described above) for noncoverage under the at risk limitation, the taxpayer's basis for depreciation of his share of the production costs of the film may include costs financed through nonrecourse loans (subject to the limitations described above).

Effective dates

Under the committee amendment, the at risk rule is to apply to losses attributable to amounts paid or incurred (or amounts allowable as depreciation or amortization) after December 31, 1975 (in taxable years ending after that date). The capitalization requirement applies to costs of producing, displaying or distributing a film (i.e. a production partnership) or other similar property, if such costs are paid or incurred after December 31, 1975, and the principal production of the property began after that date. In the case of a film, principal production means principal photography; in the case of a sound recording, principal production is the date of the recording; in the case of a book, principal production begins with the preparation of the material for publication; in the case of other similar property, the commencement of principal production is to be determined in accordance with regulations.

As indicated above, in the case of both the film purchase shelter and the "production company" shelter there are some substantial questions under present law as to whether the deductions which are claimed in connection with some of these shelters are allowable. (Such questions include the amount of depreciation which may be claimed, whether the deduction or capitalization is the appropriate treatment with respect to costs of production, and whether nonrecourse loans should be treated as debt or equity, etc.) In establishing transition rules with respect to the new restrictions on the deductibility of these items as added by the committee amendment, the committee intends to make clear that these transition rules are not to be read as implying that deductions not otherwise allowable under present law are to be allowable until the capitalization requirement and at the risk rule take effect. No inference is intended that such deductions are allowable under present law and, quite to the contrary, it appears that, at least under certain facts and circumstances, the questions as to the nonallowability of certain of these deductions under present law are very substantial.

Revenue effect

It is estimated that the provisions with respect to the capitalization requirement will result in an increase in tax liability of $26 million for calendar year 1976, $20 million for 1977, $10 million for 1978, and $4 million for 1981.

b. Clarification of Definiton of Produced Film Rents (sec. 208 of the bill and sec. 543 of the Code)

Present law

Under present law, a corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and where at least 60 percent of the corporation's adjusted ordinary gross income comes from specified types of income.

One income category treated as personal holding company income is "produced film rents." Generally, this category covers payments received by the corporation from the distribution and exhibition of motion picture films if these rents arise from an "interest" in the film acquired before its production was substantially completed (sec. 543 (a)(5)(B)). Produced film rents are not treated as personal holding company income, however, if such rents constitute 50 percent or more of the corporation's ordinary gross income. The qualifying rental interest under this category is one which arises from participation in the production of the film. In such cases Congress has regarded production activities as an active business enterprise.

Amounts received pursuant to a contract under which the corporation is to furnish personal services may be classified, under certain conditions, as personal holding company income (sec. 543(a)(7)).

These statutory rules affect, among others, independent motion picture and television producers, actors, directors, writers, etc. (or persons possessing more than one of these skills), who form corporations through which they participate in making motion picture or television films.

Reasons for change

A question concerning the proper definition of produced film rents, for purposes of the personal holding company rules, has resulted from a recent decision by the Tax Court [1] which denied depreciation deductions to an independent production company which produced an original motion picture with nonrecourse financing supplied by a major studio-distributor under an agreement that, on completion, all rights to the picture except a share in distribution profits vested in the distributor. The court held that, in these circumstances, the production company had no ownership interest in the film after it was completed and therefore could not depreciate the costs of producing film.

Although this case involved depreciation rather than personal holding company issues, it appears that the Internal Revenue Service has interpreted the decision to require that an "interest" in a film, for purposes of the definition of produced film rents in sec. 543(a)(5), must be a depreciable interest. If a production company has only a profit participation after the picture is completed and released, but legally does not have an ownership interest sufficient to claim depreciation, some revenue agents have treated all of the company's income as personal service contract income (under sec. 543(a)(7) of present law).

The committee decided that a production company does not have to have a depreciable interest in a picture it makes in order for its profits interest to qualify as produced film rents. The test under section 543(a)(5) should be whether the company in fact produced the film.

Explanation of provision

In order to avoid ambiguities, the committee amends present law (sec. 543(a)(5)(B)) to set forth more clearly the ature of the qualifying "interest" in a film. In the case of a producer who actively participates in producing a film, the term "produced films rents" will include an interest in the proceeds or profits from the film, but only to the extent that this interest is attributable to active participation in production activities.[2]

Under this provision, a production company will be considered a "producer" if it engages in production activities and is involved in principal photography or taping of the production. The term "producer" also includes participation in qualifying production activities as a co-producer.

Qualifying production activities cover preproduction activities, principal photography or taping, and postproduction functions necessary to produce a film or television tape. Preproduction activities include acquiring literary rights on which the film is to be based; developing a shooting script, supervising writers, preparing budgets, scouting locations and employing crews to be involved in the production. Activities during principal photography (or taping) include administration of budgeted items, contracting for production facilities, actual filming or taping and reviewing rough cuts. Postproduction activities include film editing, dubbing, musical scoring, synchronizing, showings to exhibitors or other previewers, re-editing and delivering the completed film (or tape) for showing to the public.

[1] Carnegie Productions, Inc., 59 T.C. 642 (1973).

[2] Other requirements in the existing definition of produced film rents must also be satisfied, namely, that the payments received by the producer are for the use of, or right to use, the film and that the interest must be acquired before substantial completion of production of the film.

If the income of a corporation qualifies as produced film rents under this provision, as amended, the committee believes that such income should not be subject to being treated as income from personal service contracts (for purposes of section 543(a)(7)).

On the other hand, if all or part of the conduct c? production activities lacks substance or is otherwise not bona fide (such as a corporation which primarily provides the services of an actor or actress who is nominally named "producer"), the Service is not to be precluded from attributing part of the company's income to personal service contracts (if the requirements of sec. 543(a)(7) are otherwise present).[3]

The committee does not intend the amendment made by this provision to affect depreciation questions, e.g., whether a production company owns a depreciable interest in a film financed by nonrecourse loans.

The committee amendment is essentially the same as the House bill provision.

Effective date

This amendment applies to taxable years ending on or after December 31, 1975. The committee intends that no inference should be drawn from this change as to whether, before the effective date of this amendment, the definition of produced film rents required the corporation to have a depreciable interest in the film under production.

Revenue effect

It is estimated that this provision will result in a reduction in tax liability of less than $5 million annually.

6. Equipment Leasing—Limitation of Loss to Amount At Risk (sec. 202 of the bill and sec. 465 of the Code)

Present law

Accelerated depreciation.—Under present law, the owner of personal property used for the production of income may generally claim annual deductions for depreciation to reflect the approximate decline in the value of the property over the period of the owner's use of the property. These depreciation deductions are also available where the owner is not the actual user of the property, such as in a leasing transaction where the owner leases the depreciable property to another party who uses the property for the production of income. In certain cases where title to the depreciable property is held for the benefit of individual investors by a legal entity, such as a partnership or grantor trust, the depreciation deductions are, under present law, passed through to the individual taxpayers who own the actual beneficial interests in the property and are deducted on their income tax returns.

There are a number of depreciation methods available under present law. One depreciation method for tangible personal property is the straight-line method, under which an equal portion of the property's depreciable basis is deducted each year of the property's useful life.

[3] A corporation which "loans out" the services of an actor, writer, director, or individual producer employed by it to another company which produces the picture should also not be considered to receive produced film rents. In that type of case, the loaned-out employee does not assume the business risks involved in producing the picture.

Equipment leasing transactions are often characterized, however, by use of one of the accelerated methods of tax depreciation which allow large deductions initially, with gradually reduced deductions for each successive year of the asset's useful life. The accelerated depreciation methods allowed for productive equipment include the double-declining balance method and the sum-of-the-years-digits method.

Additional first-year depreciation.—An owner of equipment is also eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of the property (Sec. 179). The amount on which this "bonus" depreciation is calculated is limited to $10,000 ($20,000 for an individual who files a joint return). Bonus depreciation is also available only for property that has a useful life of six years or more. The maximum bonus depreciation is then limited to $2,000 ($4,000 for an individual filing a joint return).

Where the lessor is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitation described above is applied to the individual partners rather than the partnership entity. For example, each one of 40 individual investors who contributed $5,000 to an equipment leasing limited partnership, which purchased a $1 million executive aircraft on a leveraged basis, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would provide a total deduction to the partners of $160,000.

The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim, and the partners to deduct, accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

Asset depreciation range (ADR).—The ADR system for depreciation was authorized by the Congress in the Revenue Act of 1971 in order to bolster a lagging economy and to eliminate a number of difficult interpretative problems pertaining to depreciation which had arisen under prior law. The ADR system operates under regulations issued by the Treasury Department, and became effective in 1971. (Reg. § 1.167(a)-11.)

One of the important features of ADR is that taxpayers are allowed to depreciate tangible personal property, including leased property, over useful lives which may vary up to 20 percent from the guideline lives which are otherwise authorized for use under the ADR system.

This means, for example, that an asset with a depreciable useful life of 10 years under the ADR guidelines may instead be depreciated over a period of 8 years, giving the taxpayer a type of "accelerated" depreciation deduction even with straight-line depreciation.[1]

Rapid amortization.—Certain categories of assets which are subject to equipment leasing transactions are eligible for rapid amortization.

[1] In computing depreciation under the ADR system, a taxpayer also is entitled to use one of two first-year "conventions," or methods, on all assets first placed in service during any one tax year or period. Under the first of these conventions, the taxpayer may elect to claim a half-year's depreciation on all assets put into service at any time during the year. The other convention allows a full year's depreciation for all assets placed in service during the first half of the tax year and no depreciation (for the first year) on assets placed in service during the last half of the tax year.

Under the rapid amortization provisions, the costs for qualifying categories of property may be amortized over a period of 60 months in lieu of depreciation deductions otherwise allowable for these assets. Rapid amortization is allowed for pollution control facilities(sec. 169), railroad rolling stock (sec. 184), and coal mine safety equipment (sec. 187). These provisions expired at the end of 1975.[2]

Depreciation recapture.—The equipment leasing venture does not give rise to the "conversion" characteristic common in many other types of tax shelters because of the full recapture rules that apply to dispositions of depreciated personal property. When personal property is disposed of at a gain, the gain is "recaptured" as ordinary income to the extent of all previous depreciation or amortization deductions claimed on the property (not just accelerated deductions). The recapture treatment for depreciable personal property thus differs from that accorded depreciable real property, which is generally limited to a recapture of the amount by which accelerated depreciation deductions claimed exceed those allowable on a straight-line basis.

In the case of a partnership, the individual partners are generally allocated a share of the partnership's depreciation recapture in accordance with the provisions of the partnership agreement concerning the allocation of partnership gains. The recognition of depreciation recapture by a partner may be triggered directly by a sale of the depreciated partnership property or indirectly by a disposition of the partner's interest in the partnership itself. Also, if a lender forecloses on the debt used to finance the partnership's purchase of the equipment, this is treated as a disposition which will trigger recapture. The amount "received" in a foreclosure will include the unpaid nonrecourse debt. If this amount exceeds the undepreciated basis in the equipment, there will be so-called "phantom gain" which is taxed as ordinary income to the partners.

Limitation on deduction of losses.—Generally, the amount of losses which a taxpayer is permitted to claim in connection with a business or investment property is limited to the amount of his basis in the property. Likewise, in the case of a partnership, the amount of losses a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership. However, under present law, basis in a property may include nonrecourse indebtedness (i.e., a loan on which there is no personal liability) attributable to that property, and where a partnership incurs a debt and none of the partners have personal liability on the loan, then all of the partners are treated for tax purposes as though they shared the liability in proportion to their profits interest in the partnership (i.e., each partner's share in the nonrecourse indebtedness is added to this basis in the partnership). (See regulations § 1.752–1(e).)

Also, there is generally no limitation on the amount of deductions that can be taken in situations where the taxpayer is protected against ultimate loss by reason of a stop-loss order, guarantee, guaranteed repurchase agreement, insurance or otherwise.

[2] However, amortization for pollution control facilities is revived under a committee amendment in this bill.

Reasons for change

A business may acquire productive equipment in a variety of ways, including an outright purchase or a lease of the equipment. Although an outright purchase remains the most common form of acquiring the use of equipment, recent years have shown a substantial growth in the leasing alternative. Some of the more common types of property and equipment which are presently leased include computers, aircraft, railroad rolling stock, ships and vessels, and oil drilling rigs. Also, utility companies have begun to lease the nuclear fuel assemblies used in their generating plants.

There are several reasons for the growth in equipment leasing. From the standpoint of the business lessee who uses the equipment, one factor, for example, is the opportunity to acquire use of the equipment in a manner which, in comparison with the purchase alternative, places less strain upon the available cash of the business. Another important advantage for the lessee is that leasing provides greater tax benefits through the ability to deduct its rental costs. There are also significant tax benefits to the lessor in an equipment leasing transaction (such as accelerated depreciation deductions, as discussed above) which attract the participation of individual investors.

The equipment leasing tax shelter generally operates through the limited partnership form of business organization, with the individual investors participating as limited partners. All, or virtually all, of the equity capital of the venture is contributed by the limited partners and non-recourse financing is obtained for 75–80 percent of the cost of the equipment which is purchased by the partnership and leased to a business user. The partnership generally leases the equipment to the lessee at a rental rate which, over the initial term of the lease, will enable the partnership to repay the loan, plus interest, fees and other expenses, and generate a modest positive cash flow.

In most leasing shelters, the limited partnership elects the method of depreciation or amortization which will generate the largest capital recovery deductions allowable in the early years of the lease. The partnership may, in addition, prepay some of its interest charges, and often, during the first year of operation, pays the promoter for management and syndication fees. The large depreciation, fees, interest, and other expenses generally exceed the partnership's receipts from rental of the equipment during the first 3–7 years of the lease (depending upon the estimated useful life of the leased equipment), and this generates sizable losses for the partnership.

Partnership losses are allocated to the investor-limited partners under the partnership agreement and are used by the individual investors to offset income from other sources (and thus defer taxes on this income for a number of years). The individual investor may also obtain an apportioned share of the investment credit if the equipment is eligible for the credit and the lease is of a type which enables an individual investor to claim the credit.

Because of the present tax situation, when an investment is solicited in an equipment leasing venture, it has become common practice to promise a prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources. The committee believes that it is not equitable to allow these individual investors to defer tax on income from other sources through losses generated by equipment leasing transactions, to the extent the losses exceed the amount of actual investment the taxpayer has placed at risk in the transaction. This arises principally through the use of nonrecourse financing utilized by the leasing venture, and also through guarantees, stop-loss agreements, insurance and other devices.

This leveraging of investments to produce tax savings in excess of amounts invested substantially alters the economic substance of the investment and distorts the workings of the investment markets. Taxpayers, ignoring the possible tax consequences in later years, can be led into investments which are otherwise economically unsound and which constitute an unproductive use of the taxpayer's (and the federal government's) investment funds.

The House bill applied the limitation on artificial losses (LAL) provision to equipment leasing shelters in an attempt to limit the deductions available to the amount of income earned in the year. The committee believes that the "at risk" rule provided in its amendment with respect to equipment leasing shelters deals directly with the problem involved in the shelter. As indicated in the minimum tax section above, the committee amendment is the same as the House bill with respect to continuing as a tax preference item subject to the minimum tax accelerated depreciation in the case of leases and by broadening it to cover all leases rather than just "net" leases, as under present law.

Explanation of provision

The committee amendment provides that where an individual taxpayer may otherwise be entitled to deduct a loss in excess of his economic investment in an equipment leasing activity, the amount of the loss deduction is limited to the aggregate amount with respect to which the taxpayer is at risk in this trade or business at the close of the taxable year. This "at risk" limitation applies to all individual taxpayers who invest in an equipment leasing activity, including both individuals who invest for their own account and those who do so through another entity such as a partnership or a subchapter S corporation. In addition, the limitation extends to trusts and estates, which are taxed like individuals. The House bill did not apply the at risk rule to equipment leasing.

For more detail as to the application and scope of the risk rule, see section 1, above.

Under the at risk rule as it applies to equipment leasing, the taxpayer is considered to be in a leasing activity if he has an ownership interest, either direct or indirect, in section 1245 property (as defined in sec. 1245(a)(3)) which is leased or held for leasing. In the case where equipment leasing activity is conducted by an individual, the at risk limitation applies separately to each separate property leased or held for leasing. (However, where several properties, such as parts of a computer, comprise one unit under the same lease agreement and are neither separately financed nor are subject to different lease terms, the properties are to be considered one property for purposes of the at risk rule.)

All equipment leasing activities engaged in by a subchapter S corporation or a partnership respectively will be treated as one activity under this provision. However, if the partnership or corporation engages in more than one type of activity covered by the at risk rule, then each type of activity is treated as a separate activity. For example, if a partnership has one farm and a number of equipment leasing transactions, it will be considered to have two activities, farming and equipment leasing, and a separate application of the at risk limitation must be made for each of the two activities.

Effective date

The at risk rule for equipment leasing will apply to losses attributable to amounts paid or incurred after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $6 million in fiscal year 1977, $14 million in fiscal year 1978, and $14 million in fiscal year 1981.

7. Sports Franchises and Player Contracts (sec. 209 of the bill and sec. 1245 and new sec. 1056 of the Code)

Present law

Under present law, the cost of tangible property used in a taxpayer's trade or business may be depreciated and deducted over the useful life of the property. In the case of a sports franchise, players' contracts (contracts for the services of athletes) are intangible assets and usually represent one of the important costs incurred in connection with the acquisition of the franchise. It is the position of the IRS (as described below) that player contracts have a useful life of more than one year and therefore the cost of acquiring a player's contract is to be capitalized and depreciated over the life of the contract. While the terms of players' contracts vary with the type of sport involved, the typical contract will provide employment for one year and give the employer (the team) a unilateral option to renew the contract for an additional year at a specified percentage of the player's previous salary.[1]

In 1967, the Commissioner of Internal Revenue ruled that the cost of a player's contract must be capitalized and depreciated over the useful life of the contract. (Rev. Rul. 67–379, 1967–2 C.B. 127.) In adopting this position, the IRS noted that by reason of the reserve clause, a player contract has a useful life extending beyond the taxable year in which the contract was acquired. In Rev. Rul. 71–137, 1971–1 C.B.

[1] Baseball and hockey contracts contain a specific "reserve clause" in which the right to renew the contract is itself renewed. Although the team obligates itself for only one year, the effect of this reserve clause in the contract, and certain league rules, is to bind the player to play only for the team which owns the contract. Under league rules, if the player refuses to sign a new contract or play for an additional year under the terms contained in the original contract, the team can prevent the player from playing for another team. Basketball and football player contracts purport to be less restrictive in that although they provide an option for an additional year's contract, they do not contain a reserve clause *per se*. Neither the contract nor the league rules prevent the player from "playing out his option" and becoming a "free agent." However, in the case of football, if a player becoming a free agent signs a contract with a different team in the NFL, then unless mutually satisfactory arrangements have been reached between the two league teams, the Commissioner of the NFL can assert the right to award to the former team one or more players (including future draft choices) of the acquiring team. This right is currently being litigated.

104, the same result was reached with respect to football contracts by virtue of the option clause under the contract. Although the useful life varies from sport to sport, sports teams typically adopt a maximum life ranging between three and six years. The cost to be capitalized includes amounts paid or incurred upon purchase of a player contract and bonuses paid to players for signing contracts.

The depreciable basis of player contracts also affects the current capitalization and depreciation of bonus payments to be made in the future under the terms of the contract. Generally, an accrual basis taxpayer is entitled to deduct an unpaid expense for the taxable year in which all the events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461–1(a)(2)). Under this general, rule, accrued salaries would ordinarily be deductible expenses for the taxable year in which earned by the employees even if paid in the following taxable year. However, any expenditure which results in the acquisition of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible for the taxable year in which the liability for the expenditure was incurred. This limitation would generally apply to amounts required to be capitalized with respect to a liability for future payments under a player contract.

In addition, another specific limitation would also apply in the case of such a contract if it is treated as a nonqualified deferred compensation plan. An employer is not entitled to deduct contributions made to or under a nonqualified deferred compensation plan, usually a trust, until the taxable year in which an amount attributable to the contribution is includible in the gross income of the employee. (sec. 404 (a)(5). The employee-beneficiary of such a nonexistent trust must generally include amounts paid on his behalf in his taxable year in which there is no substantial risk of forfeiture (secs. 83, 402(b), and 403(c)). In addition, the Internal Revenue Service has ruled that if compensation is paid by an employer directly to a former employee, under an unfunded plan, such amounts are deductible when *actually* paid in cash or other property (Rev. Rul. 60–31, 1960–1 C.B. 174). Thus, the deferred compensation rules would preclude the allowance of a deduction under an unfunded plan before the team makes the payment where the useful life of the player contract is shorter than the actual payout period.

When there is a sale or exchange of a sports franchise, both the buyer and the seller must generally make an allocation of the consideration for the sale or exchange between the various assets acquired or sold. Franchise rights are not usually depreciable because these rights exist for an unlimited period of time. Therefore, a purchaser of a sports team will benefit from larger depreciation deductions if he is able to allocate more of the aggregate purchase price to player contracts and less to franchise rights. There is no specific rule under present law relating to the allocation of a portion of the total consideration paid to acquire a franchise, players' contracts and other assets which might be acquired at the time of acquisition of a franchise. Generally, this allocation is made on the basis of the fair market values (or relative fair market values) of the various assets. The allocation to players' contracts is also necessary when a new franchise is acquired through the expansion of an existing league or the formation of a new league.

Under present law, depreciable property that is used in a trade or business is not treated as a capital asset. However, (under section 1231), a taxpayer who sells property used in his trade or business benefits from special tax treatment. All gains and loses from section 1231 property are aggregated for the taxable year and any gain is treated as capital gain. If the losses exceed the gains, the loss is treated as an ordinary loss. Thus, gains from the sale of player contracts will be treated as capital gain and taxed at the more favorable capital gain rates if the contracts were held for more than 6 months, to the extent such gains are not "recaptured" as ordinary income under section 1245.[2]

Reasons for change

In many cases, the tax benefits which can be derived from investing in a sports franchise combine to transform an otherwise unprofitable investment into a very profitable one. In addition, the tax benefits to some extent may have increased the price of sports franchises.

One practice that increases the tax benefits resulting from the operation of a sports franchise is the allocation of a large part of the amount paid for the acquisition of a sports team to player contracts. Typically, a purchaser of a sports franchise attempts to allocate most of the aggregate purchase price of the franchise to player contracts because the cost of a player contract may be depreciated over the life of the contract.[3] Amounts that are allocated to other assets such as the franchise rights or to goodwill cannot be depreciated because these assets have an indeterminate useful life.

On the other hand, the seller attempts to allocate most of the aggregate sales price to franchise rights. In this way, a greater amount of any gain is treated as capital gain and a lesser amount is treated as gain attributable to depreciable assets (e.g., players' contracts) subject to recapture as ordinary income.

[2] The Internal Revenue Service has ruled that gains from the disposition of depreciable professional baseball and football player contracts which are owned by teams for more than 6 months are subject to recapture as ordinary income. [Rev. Rul. 67–380, 1967–2 C.B. 291; Rev. Rul. 71–137, 1971–1 C.B. 104.]

[3] Of the total cash consideration paid for an expansion major league football team, the Atlanta Falcons, the purchaser (a subchapter S corporation) treated $7,722,914 as the cost of player contracts and options, $727,086 as deferred interest and the remaining $50,000 as the cost of the franchise. This resulted in tax losses to the corporation of $506,329 in 1967 and $581,047 in 1968 which was passed through to the shareholders on a proportionate basis. Upon audit, the IRS determined that only $1,050,000 should be allocated to the player contracts and options, and $6,722,914 should be allocated to the nondepreciable cost of the National Football League franchise. The taxpayer paid the additional assessment, submitted a claim for refund, and after its disallowance, filed a suit for refund. The court rejected both the taxpayer's initial allocation of $7,722,914 and the Commissioner's allocation of $1,050,000 and concluded that the amount that should have been allocated to the players' contracts and options was $3,035,000. (*Laird v. U.S.*, 391 F. Supp. 656, 75–1 U.S.T.C. Par. 9274 (N.D. Ga. 1975)). The court further concluded that $4,277,043 represented the value of the television rights granted to the Atlanta Falcons under a 4-year contract between the NFL and the CBS television network and that this amount was not amortizable because the useful life of the television rights was for an indefinite period. The case is presently on appeal in the Fifth Circuit.

Questions have been raised as to the method used by the District Court in allocating the purchase price to the various assets acquired in the *Laird* case. Although the court held that the right to participate in receipts from television contracts could not be depreciated since it "had no definite limited useful life the duration of which could be ascertained with reasonable accuracy", the court relied upon the existing 4-year contract in valuing this right for purposes of allocating the purchase price. Concern has been expressed as to whether, if the television contract had only 1 year left at the time of acquisition, the court would have determined the contract's value to be the present value of the right to receive television receipts for only 1 year.

With respect to recapture upon sale or disposition of a player contract, some argue that the recapture rules for depreciable personal property do not apply in light of the past treatment of salary contracts by the Internal Revenue Service. Prior to its 1967 ruling, the Service treated payments made under a salary contract as ordinary and necessary business expenses when paid. Further, salary expenses which are not capitalized would not be subject to recapture as ordinary income under the judicial tax benefit rule.

Since under present law, depreciation with respect to player contracts is recaptured on a contract by contract basis, a substantial amount of depreciation allowed will normally not be recaptured since many of the original players will have retired or will have been "cut" and replaced by new players. In addition, an abandonment loss is allowed for the adjusted basis of the player contract in the year a player retired or was cut. To the extent that gain attributable to player contracts is not recaptured, it can be argued that the taxpayer has converted an ordinary deduction into capital gain. Since the amount allocated to player contracts is usually a large portion of the acquisition cost of a sports franchise and may be depreciated over a short life, the amount allowed as a deduction in the early years in most cases is in excess of the income generated by the sports franchise for that year, which produces a tax loss.

The committee believed it was appropriate to deal directly with the tax treatment of player contracts in these cases since the concern has been with the allocation of basis to player contracts in the case of a sale or exchange of a sports franchise and the conversion of ordinary income into capital gain upon a subsequent sale. As a result, the committee amendment in general provides that the purchase price allocated to player contracts by the purchaser cannot exceed the amount of the sales price allocated to those contracts by the seller and also upon the subsequent sale of the franchise by the purchaser, the committee amendment generally provides for the recapture of the depreciation taken (or any abandonment of losses) on the player contracts which were initially acquired with the original acquisition of the franchise by the seller.

The House bill applied similar rules as in the committee amendment but also applied the limitation on artificial loss (LAL) provision to the depreciation deduction on player contracts in an attempt to limit the deductions available to the amount of income earned in the year. It also presumed that no more than 50 percent of the purchase price of a team should be allocated to player contracts unless it is proved to the contrary. The House bill further provided that depreciation attributable to player contracts which are acquired in connection with a sale or exchange of sports franchises is to be treated as an item of tax preference for purposes of the minimum tax to the extent not deferred because of the application of LAL. The committee believes that the treatment provided in its amendment with respect to player contracts deals directly with these problems and that it is not necessary to apply LAL to depreciation on player contracts, include this as an item of tax preference or to require any presumption as to allocations to player contracts.

Explanation of provision

The committee amendment provides that in the case of the sale or exchange of a sports franchise (or the creation of a new franchise), the amount of consideration allocated to a player contract by the transferee shall not exceed the sum of the adjusted basis of the contract in the hands of the transferor immediately before the transfer and the gain (if any) recognized by the transferor on the transfer of the player contract. In this way, the committee believes that a more appropriate allocation will be achieved since, to a substantial extent the buyer and seller will be adverse parties with respect to the allocation (i.e., to the extent that the amount of gain attributable to player contracts will be fully recaptured as ordinary income, the buyer and seller will be operating at arms-length with respect to the allocation). This limitation is not to apply to a like-kind exchange under section 1031 of the code. In addition, the provision is not to apply with respect to the determination of basis of the player contract in the hands of a person acquiring the contract from a decedent.

Under this provision, the transferor must provide both the Secretary and transferee with information stating the amount which the transferor believes to be the adjusted basis in the player contract, the amount which the transferor believes to be the gain (if any) recognized on the transfer of the player contract and any subsequent modification to either amount. The time and manner for furnishing this information is to be provided by regulations prescribed by the Secretary. Further, these amounts are to be binding on both the transferor and the transferee to the extent provided in such regulations.

In addition, the committee amendment makes it clear that the ordinary income treatment (under sec. 1245) applies to gain from the disposition of a player contract, or any other intangible asset, which is or has been property of a character subject to the allowance for depreciation. These provisions of the committee amendment are the same as that contained in the House bill.

The committee amendment provides special rules for the recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules would apply only in the case of the sale or exchange of the entire sports franchise and not in the case of the sale or exchange of individual player contracts.[2] For this purpose. it is intended that the sale of a substantial portion of the assets will be treated as the sale of the entire sports franchise. Under these special rules, to the extent of any gain attributable to player contracts, the amount recaptured as ordinary income would be the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise. To the extent that depreciation taken on player contracts which were acquired as part of the original acquisition of the franchise has previously been recaptured, the amount so recaptured will reduce the aggregate amount of depreciation taken into

[2] The sale of an individual player contract will continue to be governed by the general recapture rules of sec. 1245.

account in (1) above. These new rules will apply only to the seller of a sports franchise who acquired the franchise after December 31, 1975.

Effective dates

The provision relating to the allocation of the consideration to player contracts is to apply to sports franchises acquired after December 31, 1975. The provision relating to the recapture of depreciation and losses is to apply to the seller of a sports franchise which was acquired by him after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $5 million in fiscal year 1977, $5 million in fiscal year 1978, and $6 million in fiscal year 1981.

8. Partnership Provisions

a. Partnership Additional First-Year Depreciation (sec. 210(a) of the bill and sec. 179(d) of the Code)

Present law

An owner of tangible personal property is eligible to elect, for the first year the property is depreciated, a deduction for additional first-year depreciation of 20 percent of the cost of the property (sec. 179). The cost of the property on which this "bonus" depreciation is calculated is not to exceed $10,000 ($20,000 for an individual who files a joint return). The maximum bonus depreciation deduction is thus limited to $2,000 ($4,000 for an individual filing a joint return). Bonus depreciation is available only for property that has a useful life of six years or more.

Where the owner is a partnership, the election for bonus depreciation is made by the partnership. However, the dollar limitation described above is applied to the individual partners rather than to the partnership entity. For example, each one of 40 individual investors who contributes $5,000 to an equipment leasing limited partnership, which purchases a $1 million executive aircraft, would be entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation would provide total deductions to the partners of $160,000.

A corporation, however, is allowed to deduct only $2,000 of additional first-year depreciation. Thus, in the case of the purchase of an aircraft, as described above, a corporation would be limited to $2,000 of additional first-year depreciation, whereas the partnership would pass through to the partners total first-year additional depreciation of $160,000.

The additional first-year depreciation reduces the depreciable basis of the equipment. However, the partnership is still entitled to claim (and the partners to deduct) accelerated depreciation on the reduced basis in the property both for the first year and for the later years of the property's useful life.

Reasons for change

The committee believes that allowing each individual partner in a partnership to have the full $2,000 first-year depreciation deduction (or $4,000, in the case of a married partner filing a joint return) inflates the amount of "bonus depreciation" which should be allowable in the year the property is placed in service.

The present allowance (sec. 179) was enacted to provide a special incentive for small businesses to make investments in depreciable property. The limitations on the dollar amount of property with respect to which a taxpayer can take additional first-year depreciation were intended to insure that this provision allow only a very limited dollar benefit to any enterprise, regardless of size. The dollar limitation was thus intended to insure that the allowance for additional first-year depreciation would be of significance primarily for small businesses. In practice, however, the lack of a dollar limitation on the amount of depreciable basis that a partnership could pass through to its partners—even though there is a dollar limitation which applies to each partner—has enabled partnerships with many partners, especially tax-shelter partnerships, to pass through amounts of bonus depreciation very substantially in excess of what was intended to be allowed.

Explanation of provision

The committee amendment provides that, with respect to a partnership, the cost of the property on which additional first-year depreciation is calculated for the partnership as a whole is not to exceed $10,000. This provision does not affect the dollar limitation which is applicable to the individual partners.[1] Thus, for example, if a single individual is a member of a partnership and also owns a sole proprietorship the total amount of the cost basis of property on which he can take additional first-year depreciation is $10,000.

Effective date

This provision is effective for partnership taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision and the three following partnership provisions will result in an increase in budget receipts of $10 million annually.

b. Partnership Syndication and Organization Fees (sec. 210(b) of the bill and secs. 707(c) and 709 of the Code)

Present law

Present law provides for the deduction by a partnership of so-called "guaranteed payments" made to a partner for services or for the use of capital to the extent the payments are determined without regard to the income of a partnership (sec. 707(c).[2] However, the code generally provides that no current deduction shall be allowed for capital expenditures (sec. 263). Nonetheless, it is contended that, under present law, these payments under section 707(c) are

[1] A situation in which dollar limitations are imposed both at the partner level and at the partnership level involves the dollar limitation on used property which qualifies for the investment credit (sec. 48(c)(2)(D)).

[2] This section provides as follows: "To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)."

automatically deductible by the partnership without regard to the "ordinary and necessary" requirements of section 162(a) or section 263.

In support of this contention, portions of the legislative history[3] and the regulations[4] are pointed to as indicating that a partnership's payments of a salary to a partner are deductible without regard to whether the services for which such salary is rendered are capital in nature.

Thus, until recently, it has been the common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. However, in recently issued Rev. Rul. 75–214 (1975–1 C.B. 185), the Internal Revenue Service ruled that payments made by a partnership to a general partner to reimburse him for costs of organizing the partnership and for selling the limited partnership interests were not automatically deductible by virtue of section 707(c), but rather were capital expenditures under section 263.[5] The ruling stated that: "For purposes of either section 707(a) or section 707(c) of the code, payments to partners for services on behalf of the partnership may be deducted by the partnership only if such payments would otherwise be deductible (under section 162) if they had been made to persons who are not members of the partnership."

Similarly, the Tax Court, in *Jackson E. Cagle, Jr.*, 63 T.C. 86 (1974) (on appeal to C.A. 5), disallowed deductions for partners' shares of payments made by a partnership to another partner for services rendered in conducting a feasibility study of a proposed office-showroom facility, obtaining financing, and developing a building for the partnership. In this decision, the Tax Court expressly rejected the contention that Congress, in enacting section 707(c), had intended to make guaranteed payments to partners automatically deductible to the partnership without regard to sections 162(a) and 263.

Reasons for change

The committee believes that the correct interpretation of section 707(c) is the interpretation given that subsection by the Internal Revenue Service and the Tax Court, as discussed above. However,

[3] With respect to section 707(c). S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., p. 387 (1954) provided:

"Subsection (c) provides a rule with respect to guaranteed payments to members of a partnership. A partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated, to the extent of such amount, as one who is not a partner, and *the partnership shall be allowed a deduction for a business expense*. The amount of such payment shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income or gain. A partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a fixed payment in that amount. (Emphasis supplied.)" To the same effect, H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., pp. 68, A226–227.

[4] Sec. 1.707–1(c), Income Tax Regs., provides, in pertinent part, as follows:

"(c) *Guaranteed payments.* Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of § 1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses) * * *"

[5] In a case under the 1939 Code, the Tax Court held that expenditures for the creation of a partnership were not currently deductible. *Abe Wolkowitz*, 8 CCH T.C.M. 754, 772 (1954).

despite this Tax Court decision and this Revenue Ruling, the law is not entirely clear that, to be deductible, guaranteed payments must meet the same tests under section 162(a) as if the payments had been made to a person who is not a member of the partnership. A contrary conclusion would allow partnerships to treat capital expenditures as current deductions, while a corporation incurring these expenditures would not be entitled to similar treatment.

While section 263 requires these expenditures of a corporation to be capitalized, section 248 allows the corporation to elect to amortize the organizational expenditures (as opposed to syndication-type expenditures) over a period of not less than 60 months. Under the regulations, the costs incurred by a corporation in marketing and issuing its stock are capital expenditures under section 263, but are not subject to the 60-month amortization provisions of section 248. (Regs. §1.248–1 (b)(3)(i))[6]

Explanation of provision

The committee amendment adds a new provision (sec. 709) which provides that, subject to the special amortization provision described below, no deduction shall be allowed to a partnership or to any partner under the partnership tax provisions (subchapter K of the code) for any amounts paid or incurred to organize a partnership or to promote the sale (or to sell) an interest in the partnership. The committee amendment also amends section 707(c) to make it clear that, in determining whether a guaranteed payment is deductible by the partnership, it must meet the same tests under section 162(a), as if the payment had been made to a person who is not a member of the partnership, and the normal rules of section 263 (relating to capital expenditures) must be taken into account.[7]

The committee amendment provides that a partnership could elect to deduct ratably over a period of not less than 60 months the amounts paid or incurred in organizing the partnership.[8] The organizational expenses subject to the 60-month amortization provision are defined as those expenditures which are incident to the creation of the partnership, chargeable to the capital account, and of a character which, if expended in connection with the creation of a partnership having an ascertainable life, would be amortized over that period of time.

The capitalized syndication fees, i.e., the expenditures connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs, are not to be subject to the special 60-month amortization provision.

The House bill is substantially the same as the committee amendment except that the House bill did not allow the 60-month amortization for organizational expenses.

Effective date

The provision relating to partnership syndication fees applies to taxable years beginning after December 31, 1975. The provision with

[6] For cases supporting this position, see *Davis* v. *Commissioner*, 151 F. 2d 441 (8th Cir. 1945). *cert. den.*, 327 U.S. 783; *United Carbon Company* 32 B.T.A. 1000 (1935).

[7] The committee amendment is not intended to adversely affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest.

[8] If the partnership were liquidated before the end of the 60-month period, the remaining organizational expenses would be deductible to the extent provided under the provision relating to losses (sec. 165).

respect to organization fees applies to partnership taxable years beginning after December 31, 1976.

Revenue effect

The revenue impact of these provisions is included in the estimate under (a) above.

c. *Retroactive Allocations of Partnership Income or Loss (sec. 210(c) of the bill and secs. 704(a) and 706(c) of the Code)*

Present law

Investments in tax shelter limited partnerships are commonly made toward the end of the taxable year. It is also common for the limited partnership to have been formed earlier in the year on a skeletal basis with one general partner and a so-called "dummy" limited partner. In many cases, the limited partnership incurs substantial deductible expenses prior to the year-end entry of the limited partner-investors.

In these tax shelter limited partnerships, the limited partnership usually allocates a full share of the partnership losses for the entire year to those limited partners joining at the close of the year. These are referred to as "retroactive allocations." For example, in the case of a limited partnership owning an apartment house which has been under construction for a substantial part of the year, where construction interest and certain deductible taxes have been paid during that time, such deductions might be retroactively allocated to investors entering the partnership on, say, December 28th of that year.

Present law is not clear whether retroactive allocations are permissible under the Internal Revenue Code. Essentially, there are four partnership Code provisions which have a direct or indirect bearing on this issue—sections 704(a), 761(c), 704(b)(2), and 706(c)(2)(B).

Section 704(a) provides, in effect, that except as otherwise provided in section 704, the partnership agreement will govern the manner of allocation of "income, gain, loss, deduction, or credit." With respect to a particular taxable year, section 761(c) treats a partnership agreement as consisting of any amendment made up to and including the time for which the partnership's tax return must be filed for such year. It has been argued that sections 704(a) and 761(c), particularly when read together, allow retroactive allocations. On the other hand, it has been argued that sections 704(b)(2) and/or 706(c)(2)(B), discussed below, would prohibit some or all retroactive allocations.

Section 704(b)(2) prohibits the allocation of items of income, deduction, loss or credit (such as capital gains and depreciation) where the principal purpose of the allocation is the avoidance or evasion of tax. This provision, it has been argued, would prohibit any retroactive allocation having tax avoidance as its principal purpose. The counter-argument to this claim has been that section 704(b)(2) is inapplicable to retroactive allocations of taxable income and loss, since, by its own terms, it only pertains to allocations of particular *items* of income, deduction, loss, or credit.

The main case dealing with the interpretation of section 704(b)(2) with respect to this issue is *Jean V. Kresser*, 54 T.C. 1621 (1970).[9] In

[9] Two other cases arguably providing some support for retroactive allocations are *Smith v. Commissioner*, 331 F. 2d 298 (C.A. 7, 1964), and *Norman A. Rodman*, 32 T.C.M. 1307 (1973).

Kresser, the retroactive allocation involved was disallowed upon the court's findings that the partnership agreement was not amended to provide for the allocation and the allocation of income was, in fact, nothing more than a paper transaction lacking in economic substance. One of the arguments of the Government was that section 704(b)(2) precluded the retroactive allocation. The court dealt with this contention in a footnote (*supra*, at p. 1631), which indicated support for the interpretation of section 704(b)(2) as applying only to allocations of particular items of income, deduction, or credit, and not to allocations of the composite of the partnership's income or loss. However, because of the court's initial findings (i.e., the absence of both an amendment to the partnership agreement and a bona fide reallocation of income); it did not resolve this issue.

Section 706(c)(2)(B) provides that where a partner disposes of less than his entire interest in a partnership, or his interest is reduced, the partnership taxable year does not close as to such partner, but that his distributive share of partnership income and loss is determined "by taking into account his varying interests in the partnership during the taxable year." While not specifically stated in this provision or the relevant regulations (Regs. § 1.706–1(c)(4)), it is implicit that the transferee of less than the entire interest of the transferor-partner would necessarily be subject to the same rule, i.e., his distributive share of partnership income and loss would be determined by taking into account his varying interests in the partnership during the taxable year. For example, if, on July 1, a person, who was not previously a partner, were to acquire from an existing partner a 25 percent interest in a calendar year reporting partnership, which had a loss for the year of $1,000, then, by taking into account his varying interests of zero during the first half of the year and 25 percent during the second half, $125 of the loss would be allocable to the transferee-partner.[10]

As previously stated, section 706(c)(2)(B) also applies where the interest of a partner is reduced. It is unclear whether this provision pertains to the situation where a partner's proportionate interest in the partnership is reduced as the result of the purchase of an interest directly from the partnership. Consequently, it is unclear whether an incoming partner, who purchased his interest directly from the partnership, would be subject to the rule of including partnership income and loss according to his varying innterests during the year. Some argue that the varying interests rule of section 706(c)(2)(B) is inapplicable to this situation.

It is further argued that, even if section 706(c)(2)(B) imposed the varying interests rule in the above situation, a timely amendment to the partnership agreement providing for a retroactive allocation of the entire year's losses would, pursuant to sections 704(a) and 761(c), override this provision.

Section 706(c)(2)(A) provides that where a partner retires or sells his entire interest in a partnership, the taxable year of the partnership will close and the partner's distributive share of various income and deduction items will be determined under the income tax

[10] This example assumes that no retroactive allocation is provided in the partnership agreement, which some would argue should prevail, pursuant to sections 704(a) and 761(c), over any allocation provided under section 706(c)(2)(B).

regulations. Essentially, the regulations (Regs. § 1.706–1(c) (2) (ii)) provide the alternatives of either an interim closing of the partnership books or the estimation of a partner's distributive share of income and deductions by a proration of such items for the taxable year, based upon the portion of the taxable year that had elapsed prior to the sale or retirement. These alternative methods of computation are not specifically provided, however, with respect to the sale or exchange of, or a reduction in, a partnership interest under section 706(c) (2) (B). In cases to which section 706(c) (2) (B) applies, the only guidance provided is that income and loss allocations should take into account a partner's "varying interests in the partnership during the taxable year."

Reasons for change

Under present law, it is unclear whether section 706(c) (2) (B) requires the inclusion of income and loss according to a partner's varying interests during the year where the partner's interest is acquired directly from the partnership. Even if section 706(c) (2) (B) did impose the varying interests rule in this situation, there is the further ambiguity whether a retroactive allocation provided in a partnership agreement would, under the authority of sections 704(a) and 761(c), override any allocation provided under section 706(c) (2) (B). Moreover, even if it were established that section 706(c) (2) (B) was not overriden by a retroactive allocation pursuant to sections 704(a) and 761(c), no clear method is provided in the code or regulations for taking into account the varying interests of the partners during the partnership year.

In essence, the consequence of allowing retroactive allocations is that new partners investing in the partnership towards the close of the taxable year are allowed to deduct expenses which were incurred prior to their entry into the partnership. Some argue that these retroactive allocations are proper because the funds invested by the new partners serve to reimburse the original partners for their expenditures and that, as an economic matter, the new partners have incurred the costs for which they are claiming deductions. However, this argument loses its persuasiveness when the new partner in a partnership situation is compared to that of an investor who directly purchases property which had previously generated tax losses during the taxable year. It is clear that in the latter case the investor would not be entitled to deduct the losses incurred prior to his ownership of the property, notwithstanding the fact that he may, in effect, be reimbursing the seller of the property for losses already incurred.

In order to deal with the problem of retroactive allocations and clarify the treatment of a partner's interest where the partner acquired the interest directly from the partnership, the committee amendment specifically denies retroactive allocations and provides that the present varying interests rule is to apply to a partner's interest acquired directly from the partnership.

Explanation of provision

The committee amendment amends present law (sec. 706(c) (2) (B)) to make it clear that the varying interests rule of this provision is to apply to any partner whose interest in a partnership is reduced, whether by entry of a new partner who purchased his interest directly from the partnership, partial liquidation of a partner's interest, gift, or otherwise. Correspondingly, the provision is to apply to the incoming partner so as to take into account his varying interests during the year. In addition, regulations are to apply the same alternative methods of computing allocations of income and loss to situations falling under section 706(c)(2)(B) as those now applicable to section 706(c)(2)(A) situations (sale or liquidation of an entire interest). These rules will permit a partnership to choose the easier method of prorating items according to the portion of the year for which a partner was a partner or the more precise method of an interim closing of books (as if the year had closed) which, in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners to the partnership.

In addition, the present law provision relating to the effect of a partnership agreement (sec. 704(a)) is amended to provide that it is overridden by any contrary provisions of the partnership provisions (under subchapter K, including section 706(c)(2)(B)). Thus, a partnership agreement, amended (pursuant to section 761(c)) to provide for a retroactive allocation, will not override an allocation required under section 706(c)(2)(B).

This is substantially the same provision provided in the House bill.

Effective date

These provisions are effective for taxable years of partnerships that begin after December 31, 1975. The committee does not intend that any inference be drawn as to the propriety or impropriety of a retroactive allocation under present law.

Revenue effect

The revenue impact of this provision is included in the revenue estimate under (a) above.

d. Partnership Special Allocations (sec. 210(d) of the bill and sec. 704(b) of the Code)

Present law

Under the partnership provisions, a limited (or a general) partnership agreement may allocate income, gain, loss, deduction, or credit (or items thereof) among the partners in a manner that is disproportionate to the capital contributions of such partners (sec. 704(a), (b)(1)). These are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)).

Special allocations of profits, losses, income items, and deductions may be used to combine tax-oriented and nontax-oriented investors in a single partnership. Typically, the tax benefits and large portions of the capital appreciation on resale are given to the high-income investor, while greater security and first return of cash flow are given to the nontax-oriented investor.

A special allocation will not be recognized under present law if its principal purpose is to avoid or evade a Federal tax (sec. 704(b)(2)). In determining whether a special allocation has been made principally for the avoidance of income tax, the regulations focus upon whether the special allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences (Regs. § 1.704–1(b)(2)). The regulations also inquire as to whether there was a business purpose for this special allocation, whether related items from the same source are subject to the same allocation, whether the allocation ignored normal business factors and was made after the amount of the specially allocated item could reasonably be estimated, the duration of the allocation, and the overall tax consequences of the allocation.

A primary case dealing with this issue, *Stanley C. Orrisch*, 55 T.C. 395 (1970), affirmed C.A. 9, disallowed a deduction of 100 percent of the depreciation by one of the partners in a two-man partnership. The allocation in this case was found to have been made for the principal purpose of evading or avoiding income tax, the parties failing to demonstrate any economic effect of the allocation. The court indicated that the taxpayer had not shown that he had borne the risk of economic depreciation of the property in question.

In the case of *Leon A. Harris*, 61 T.C. 770 (1974), the United States Tax Court sustained the special allocation to a partner of a loss incurred upon the sale of an interest in a shopping center, where the entire sales proceeds were distributed to that partner and his capital account was charged with the entire loss on the sale.

By its terms, the tax avoidance provisions of section 704(b)(2) apply to allocations of *items* of income, gain, loss, deduction, or credit. It is thus argued that these provisions do not apply to and would not preclude allocations of taxable income or loss, as opposed to specific items of income, gain, deduction, loss, or credit.

The main case dealing with the interpretation of section 704(b)(2) with respect to this issue is *Jean V. Kresser*, 54 T.C. 1621 (1970). In *Kresser*, a purported allocation of all a partnership's taxable income for one taxable year to one partner who had a net operating loss carryforward expiring in that year was disallowed upon the court's findings that the partnership agreement was not amended to provide for the allocation and the allocation of income was, in fact, nothing more than a paper transaction lacking in economic substance. One of the arguments of the Government was that section 704(b)(2) precluded the allocation. The court dealt with this contention in a footnote (*supra*, at p. 1631), which indicated support for the interpretation of section 704(b)(2) as applying only to allocations of particular items of income, deduction, or credit, and not to allocations of the composite of the partnership's income or loss. However, because of the court's initial findings (i.e., the absence of both an amendment to the partnership agreement and a bona fide reallocation of income), it did not resolve this issue.

Reasons for change

The committee believes that an overall allocation of the taxable income or loss for a taxable year (described under section 702(a)(9)) should be subject to disallowance in the same manner as allocations of an item of income or loss.

Also, the committee believes that allocations of special items and overall allocations should be restricted to those situations where the allocations have substantial economic effect, as presently interpreted by the regulations and case law.

Explanation of provisions

The committee amendment provides generally that an allocation of overall income or loss (described under section 702(a) (9)), or of any item of income, gain, loss, deduction, or credit (described under section 702(a) (1)-(8)), shall be controlled by the partnership agreement if the partner receiving the allocation can demonstrate that it has "substantial economic effect", i.e., whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences. (Regs. § 1.704-1 (b) (2)) Other factors that could possibly relate to the determination of the validity of an allocation are set forth under the present regulations (Regs. § 1.704-1(b) (2)).

If an allocation made by the partnership is set aside, a partner's share of the income, gain, loss, deduction or credit (or item thereof) will be determined in accordance with his interest in the partnership, taking into account all facts and circumstances.

In determining a "partner's interest in the partnership", all the facts and circumstances are to be taken into account. Among the relevant factors to be taken into account are the interests of the respective partners in profits and losses (if different from that of taxable income or loss), cash flow; and their rights to distributions of capital upon liquidation.

The House bill differs from the committee amendment in two respects. First, the committee amendment disallows a special allocation lacking "substantial economic effect", while the House bill does so with respect to a special allocation lacking "a business purpose" or where "significant avoidance or evasion of any tax . . . results from such allocation." While there is a difference in language, the intent of the committee amendment and the House bill are essentially the same—both versions seek to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes.[11]

The committee amendment provides that in the case where there is a disallowance of a special allocation, a partner's share of the income, gain, loss, deduction or credit (or item thereof) is to be determined in accordance with the partner's interest in the partnership, taking into account all facts and circumstances. The House bill provided a two-step method of reallocation which includes the provision described above in the committee amendment but also provided for the allocation to be determined in accordance with the partner's "permanent method of allocating" the taxable income or loss (described under section 702(a) (9)), if there is such a method. The committee amendment deletes this alternative because of the difficulty in defining "permanent method of allocating" the items.

Effective date

This provision applies to partnership taxable years beginning after December 31, 1975. The committee does not intend that any inference

[11] Because of the use of the phrase "significant avoidance or evasion of any tax . . . *results*" (emphasis supplied) under the House bill, a conceivable interpretation might cause the disallowance of a special allocation to a high-bracket taxpayer, notwithstanding that the allocation had a business purpose and economic substance.

be drawn as to the propriety or impropriety of a special allocation under present law.

Revenue effect

The revenue impact of this provision is included in the revenue estimate under (a) above.

9. Interest

a. Treatment of Prepaid Interest (sec. 205(a) of the bill and sec. 461(g) of the Code)

Present law

Under present law, a taxpayer may claim deductions in the year which is proper under the method of accounting which he uses in computing his taxable income (sec. 461). A taxpayer using the cash receipts and disbursements method of accounting may generally claim a deduction for interest paid within his taxable year (sec. 163(a)). However, if the taxpayer's method of accounting does not clearly reflect income, the Internal Revenue Service may recompute the income using the method which the Service believes clearly reflects income (sec. 446(b)). The income tax regulations also provide that, even under the cash method of accounting, an expense which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may be deducted only in part in the year in which payment is made.

No specific statutory provision expressly permits prepaid interest to be deducted in full when paid by a cash method taxpayer. The authority for deducting prepaid interest rests on court cases and on administrative rulings by the Service. Until the late 1960's tax-oriented investors were able to prepay as much as five years' interest with apparent approval by the courts and the Service.

In 1968, however, the Service published a revenue ruling holding that an interest prepayment by a cash-basis taxpayer for a period extending for more than 12 months beyond the end of the current taxable year will be deemed to create a material distortion of income. In such a case the interest will be allocated over the taxable years involved. Deductions for interest paid in advance for a period not in excess of 12 months after the last day of the taxable year of payment will be considered on a case-by-case basis to determine whether a material distortion of income has resulted.[1] Recent Tax Court cases have disallowed prepaid interest deductions of taxpayers in situations where the Internal Revenue Service has relied on this ruling as authority to disallow the deduction. The Tax Court has indicated, however, that it might not be willing to disallow prepaid interest in all cases where the prepayment relates to periods extending more than 12 months beyond the end of the current taxable year.

The tax treatment of a loan requiring prepaid interest or points contrasts with the tax treatment of a discount loan under present law, although in many situations the economic substance of both

[1] The ruling (Rev. Rul. 68–643, 1968–2 C.B. 76) sets forth several factors which may be considered in determining whether there is a material distortion of income: the amount of the taxpayer's income in the taxable year of payment; his income in previous years; the amount of prepaid interest; the time of payment; the reason for the prepayment; and the presence of a varying rate of interest over the term of the loan.

transactions is similar. In a discount loan, the lender delivers to the borrower an amount which is smaller than the face amount of the loan. The difference between the face amount and the amount delivered to the borrower is the charge for his use of the borrowed funds. Under present law, a borrower on the cash method cannot deduct the entire interest element in the year in which he receives the loan proceeds. He can deduct the interest element only when and as he actually repays the face amount of the loan.[2]

Reasons for change

Prepaid interest has been extensively used in many types of tax shelters to defer tax on income which would otherwise be taxable in higher marginal tax brackets. The deduction for prepaid interest has become highly important to investors seeking year-end tax losses who acquire their interests in a property (such as land, an apartment building, cattle, computers, motion pictures and the like), or in a partnership which will own the property, toward the end of the calendar year. In such cases, the investors will not be able to operate the property long enough in that taxable year to generate either income or a large amount of ordinary and necessary business expenses. Therefore, deductions arising from prepaying as much of the financing costs as possible have been central to the creation of year-end tax losses. If the investors have income from other sources, the interest deductions can be used to offset this other income (rather than offsetting income from the property itself, which will be realized in a later year). Prepaid interest thus gives a taxpayer the time value of deferring taxes on his other sources of income.[3]

The advantages of prepaying interest are especially attractive to persons who have unusually high income in a particular year and who are in a higher effective tax bracket that year than they expect to be in during later years.

In many cases a deduction for prepaid interest can be generated without adverse cash flow consequences by borrowing more money than is needed and promptly repaying the excess as "prepaid interest."[4]

A recent technique used to justify larger amounts of prepaid interest within the Service's present guidelines than can be obtained under conventional financing is the "wraparound" mortgage (sometimes referred to as an all-inclusive deed of trust). Often, a farm, shopping center or other property which investors are purchasing is encumbered by an existing first mortgage. The investors execute to the seller a new purchase money obligation whose face amount includes both the unpaid balance of the first mortgage and the new financing supplied by the seller (which would ordinarily take the

[2] See Rev. Rul. 75–12. 1975–1 C.B. 62.

[3] In some cases the investors (or their partnership) execute a purchase money mortgage note to the person who is selling the property to them. Although most sellers would ordinarily desire to receive a larger purchase price (capital gain) and less interest (ordinary income), many sellers are not adversely affected by receiving income. Some sellers may have expiring loss carryovers to absorb the interest income. Others are dealers who would realize ordinary income on the sale in any event; other sellers are pension funds, charities or other tax-exempt organizations.

[4] In some cases an interest prepayment reduces the taxpayer's cash flow (net of tax savings). However, as long as the deduction lowers the taxpayer's effective tax rate by more than the market rate of interest which he could earn on the cash he invests, the taxpayer will find it to his advantage to shelter his income by prepaying interest. (Generally, the largest reductions in effective tax rate will accrue to taxpayers in the higher marginal tax brackets.)

form of a second mortgage). The buyers agree to pay (and to prepay) interest on the face amount of the "wraparound" note, while the seller agrees to continue paying the interest on the first mortgage out of the interest payments which he receives from the buyers. Since a wraparound mortgage usually bears a higher rate of interest than the first mortgage (and in some cases the additional prepaid interest which the buyers claim on the note is negotiated as a substitute for a larger down payment), this type of arrangement has been widely used to increase the amount of interest which can be prepaid in the initial year of a purchase of property and claimed as a deduction for one year's prepaid interest within the Service's present guidelines.[5]

The committee believes that the creation of a tax shelter with prepaid interest cannot be justified even under the cash method of accounting. The policies underlying the cash method, namely, simplicity and avoidance of complex recordkeeping or computations, do not apply to prepaid interest, which can be allocated over the term of a loan.

Under present law there is considerable uncertainty as to the deductibility of prepaid interest. Under the Tax Court's holdings, the deductibility of prepaid interest depends on a case-by-case determination. Even under the Internal Revenue Service position, a case-by-case determination must be made in all cases where interest is prepaid for a period which does not extend more than 12 months beyond the taxable year in which the prepayment is made. Consequently, a deduction of prepaid interest by the same taxpayer might be allowed in one year and perhaps not in another year. Also, prepaid interest might be deductible by one taxpayer who has a large amount of income in a given year after the deduction (so that the deduction arguably does not "distort" his income) but possibly not be deductible by another taxpayer who has little or no taxable income after taking the deduction. In the case of prepaid interest, the clear reflection of income test (under present law) should focus less on comparing the interest deduction with the taxpayer's general income stream from year to year than on matching interest and other costs of carrying a particular property against its income or loss over the term of the loan.

Explanation of provision

The committee has adopted a rule which permits a cash method taxpayer to deduct prepaid interest only in the taxable year in which (and to the extent that) the interest represents a charge for the use or forbearance of borrowed money during that period.

Under this provision of the committee amendment, if a taxpayer uses the cash receipts and disbursements method to compute his taxable income, interest which he pays and which is properly allocable to any later taxable year must be charged to capital account and treated as paid by him in the periods in which (and to the extent that)

[5] The seller of property is motivated to use a wraparound mortgage because he is relending the balance of the first mortgage to the investor at a higher rate of interest than he pays to his lender. Thus the amount received as a result of the difference between the interest rates is additional profit to him.

A wraparound mortgage is also often used as a refinancing device by an owner of mortgaged property who desires to receive a new loan from a third party, who agrees to pay off the existing lien out of the payments which he receives from the borrower.

the interest represents a charge for the use or forbearance of borrowed money during each such taxable year. In determining whether an interest prepayment is properly allocable to one or more taxable years after the year of payment, the committee intends that the allocation be made to the period or periods in which the interest represents a cost of using the borrowed money in that period, regardless of whether allowing prepaid interest to be deducted when paid would materially distort the taxpayer's income in the year of payment (or the income of a partnership of which the taxpayer may be a member).

This rule applies to all taxpayers, including individuals, corporations, estates and trusts and covers interest paid for personal, business or investment purposes.

The new statutory rule relates to interest prepayments by a cash method taxpayer. It is intended to conform the tax deductibility of prepaid interest by cash method taxpayers to the rule which the committee understands to be proper under present law for interest prepayments by an accrual method taxpayer.[6]

Once prepaid interest has been allocated over the term of the loan, the interest allocable to a given taxable year will then become subject to other limitations under present law and to specific limitations imposed by other provisions of this bill. For example, interest allocated to a taxable year under this provision of the committee amendment will become subject, in turn, to the minimum tax rules added by the committee amendment under which the excess of investment interest over investment income will be treated as an item of tax preference, and to the limitation on activities not engaged in for profit (sec. 183 of present law), in each of the taxable year or years in which interest is an allowable deduction under this provision.

In adopting the new rule, the committee does not intend to change present law with regard to defining "interest." Before this provision can apply, an interest payment must be otherwise deductible as interest under present law.[7]

In certain cases, the Treasury is authorized to treat interest payments under a variable interest rate as consisting partly of interest computed under an average level effective rate of interest and partly of an interest prepayment allocable to later years of the loan.[8]

The amendment does not contemplate that interest will be treated as paid in level payments over the term of every loan. Thus, interest paid as part of a level constant payment (including principal and interest) will not be subject to this provision merely because the payments consist of a larger interest portion in the earlier years of the loan than in the later years.

[6] An accrual method taxpayer can deduct prepaid interest only in the period in which the use of money occurs and only to the extent of the interest cost of using the borrowed funds during that period. It is not material when actual payment occurs, nor is the existence of a fixed liability to make a prepayment of interest sufficient to justify a deduction. Rev. Rul. 68–643, 1968–2 C.B. 76.

[7] The committee does not intend to prevent the Treasury or the taxpayer from continuing (where appropriate) to characterize a purported "interest" payment as not true interest in the particular circumstances. It may thus be appropriate in some cases to treat a payment denominated "interest" as, in substance, additional purchase price of property, as a dividend, as payment for an option, etc.

[8] The committee does not intend, however, that a loan calling for interest at a stated rate tied to the "prime rate" necessarily involves prepaid interest, or that variations in the rate of interest as the prime rate (or some other objective measurement) varies necessarily subjects the interest payments to disallowance under this provision.

Prepaid interest on an indebtedness secured by a "wraparound mortgage" will be subject to the general rule of this provision.[9]

The committee does not intend the new rule to change the treatment of a discount loan under present law by a cash method taxpayer. Nor does the new rule prevent the Treasury from treating interest as paid under the terms of a discount loan rather than under a conventional loan as prepaid interest.

Points are additional interest charges which are usually paid when a loan is closed and which are generally imposed by the lender in lieu of a higher interest rate. Where points are paid as compensation for the use of borrowed money (and thus qualify as interest for tax purposes) rather than as payment for the lender's services, the points substitute for a higher stated annual interest rate. As such, points are similar to a prepayment of interest and, under the committee amendment, are to be treated as paid over the term of the loan. This rule also applies to charges similar to points, whether called a loan-processing fee or a premium charge.

The committee amendment permits points paid by a cash method taxpayer on an indebtedness incurred in connection with the purchase or improvement of (and secured by) his principal residence to be treated as paid in the taxable year of actual payment. A loan will not qualify under this exception, however, if the loan proceeds are used for purposes other than purchasing or improving the taxpayer's principal residence, or if loan proceeds secured by property other than his principal residence are used to purchase or improve his residence. The exception applies only to points on a home mortgage, and not to other interest costs on such a mortgage. A further limitation is that in order to qualify under this exception, the charging of points must reflect an established business practice in the geographical area where the loan is made, and also the deduction allowed under this exception may not exceed the number of points generally charged in the area for this type of transaction.

The House bill is substantially the same as the committee amendment, except that the House bill does not contain the limitation on deductibility of points.

Effective dates

The rules in this provision apply generally to any prepayment of interest (including points) after December 31, 1975.

The committee intends that no inference should be drawn concerning the deductibility of prepaid interest paid before the effective dates of the new rule. It is expected that deductions for such prepayments will be determined according to the criteria of present law.

Revenue effect

It is estimated that this provision will result in an increase in tax liability of less than $5 million annually.

[9] Since the provision focuses on the fact of prepayment as such, it is immaterial whether the borrower prepays interest (either voluntarily or contractually) to a third-party lender under the first mortgage rather than to the seller of the property. In appropriate cases, however, the committee does not intend to prevent the Service from recharacterizing part or all of a buyer's (or borrower's) "interest" payment on a wraparound mortgage as, in substance, an additional down payment of principal or as a nondeductible deposit of interest with a third party. See Rev. Rul. 75–99, 1975–1 C.B. 197.

b. Termination of Investment Interest Limitation (sec. 210(b) of the bill and sec. 163(d) of the Code)

Present law

Under present law, a taxpayer who itemizes his deductions may generally deduct all interest paid or accrued within the taxable year on his indebtedness (sec. 163). However, a limitation is imposed on interest on investment indebtedness incurred by a noncorporate taxpayer. This limitation applies to interest paid or accrued in the taxable year on indebtedness incurred or continued to purchase or carry property held for investment. Under this limitation (sec. 163(d)), investment interest may be deducted in the taxable year only up to an amount equal to the total of the taxpayer's net investment income, his long-term capital gain and $25,000, plus one-half of any investment interest in excess of these amounts. Any remaining amount may be carried over to future years and deducted within specified limits in such years. The excess of investment interest for any taxable year over investment income for the same year is not treated as an item of tax preference under the minimum tax rules of present law. (Excess investment interest was treated as a tax preference item for taxable years beginning before January 1, 1972).

Reasons for change

As indicated in the minimum tax section above, the committee is concerned about the cases where taxpayers have investment interest deductions in excess of their investment income which, as a result, allow them to reduce their taxable income in a year to a point at which little or no tax is paid. The present rules for investment interest contribute to situations of this kind. The committee believes that a preferable approach is to make the full amount of excess investment interest subject to the minimum tax. Consequently, the committee amendment changes the treatment of investment interest by making such interest an item of tax preference for purposes of the minimum tax and by repealing prospectively the present rules for investment interest. This approach differs from the House bill, which generally would limit deductions for investment interest (and also personal interest) to an amount equal to net investment income and long-term capital gains, plus $12,000 per year.

Explanation of provision

The committee amendment provides that the limitations on investment interest contained in present law shall not apply to interest paid or accrued after December 31, 1975. However, in order to take account of the fact that taxpayers may have carryovers of investment interest paid or accrued in 1975 and earlier years, the amendment continues the interest carryover rules of present law (sec. 163(d)(2)) for any such interest. This means that interest paid or accrued before 1976 which is disallowed under the present rules must be carried over to 1976 and later taxable years. The amount of carryover of pre-1976 interest which can be deducted in 1976 and later years will continue to be determined under the present carryover rules and will be subject to the limitations contained in those rules. The amount of pre-1976 disallowed interest which can be deducted in 1976 and later years must be taken into account in any such year in determining (for purposes of the revised minimum tax) whether in that year the taxpayer's investment interest exceeds his investment income.

Effective date

The limitations on investment interest contained in present law will not apply to interest paid or accrued after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by $11 million in fiscal year 1977, $12 million in fiscal year 1978, and $14 million in fiscal year 1981.

c. Limitation on Deduction of Nonbusiness Interest

The House bill contained a limitation on the deduction of nonbusiness interest (other than investment interest to the extent of investment income) to $12,000 a year.

The committee deleted this provision because it did not want to limit the deduction of mortgage interest and other types of personal interest. The deduction of excess investment interest is dealt with under the minimum tax and the deduction of prepaid interest is limited under the tax shelter provisions.

C. CHANGES IN THE MINIMUM AND MAXIMUM TAXES

1. Minimum tax (sec. 301 of the bill and secs. 56–58 of the Code)

Present law

Present law (sec. 56 of the Code) imposes a minimum tax on certain tax preferences. The minimum tax amounts to 10 percent of the sum of an individual or corporation's (or estate or trust's) tax preferences in excess of the sum of $30,000 and the taxpayer's regular income tax.[1]

The tax preference items included in the base of the minimum tax are the following:

(1) Accelerated depreciation on real property in excess of straight-line depreciation;

(2) Accelerated depreciation on personal property subject to a net lease in excess of straight-line depreciation;[2]

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));

(4) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167));

(5) Qualified or restricted stock options (the excess of the fair market value at time of exercise over the option price);

(6) Reserves for losses on bad debts of financial institutions (the excess of the special deduction for such institutions over the bad debt reserve deduction allowable on the basis of actual experience);

(7) Percentage depletion in excess of the adjusted basis of the property;

(8) Capital gains (for individuals, one-half of net long-term capital gains; for corporations in general, 18/48 of net long-term gains);[3]

(9) Amortization of on-the-job training and child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec.167)).

Special rules are provided for net operating losses and for carryovers of "unused" regular income tax deductions. In the case of net operating losses, present law provides for a deferral for part or all of the tax in a year in which the taxpayer incurs a net operating loss

[1] Regular income tax is reduced by various tax credits, such as the foreign tax and retirement income credits.

[2] The net lease provision does not apply to corporations, other than subchapter S corporations and personal holding companies.

[3] The fraction 18/48 is the difference between the ordinary corporate income tax rate of 48 percent and the corporate capital gains tax rate of 30 percent, divided by the ordinary corporate rate.

which can be carried over to a later year. In addition, there is a rule which provides that in a year in which a taxpayer has regular income tax liability (after tax credits) which exceeds his tax preference income above the $30,000 exemption level, the excess tax liability may be carried forward for 7 years and used to offset tax preference income otherwise subject to the minimum tax in those later years. Tax preferences from foreign sources are subject to the minimum tax only to the extent that they reduce regular income taxes on domestic-source income (sec. 58(g)). Tax preferences of subchapter S corporations are considered to be preferences of their shareholders.

Reasons for change

The existing minimum tax on tax preferences was enacted in 1969 in order to ensure that high-income individuals and corporations pay at least a minimum rate of tax on their tax preferences, including both exclusions from taxable income and deferrals of tax liability into future years. The current minimum tax, however, has not achieved this goal. High-income individuals still are able to avoid paying income tax, and in 1974 the minimum tax on individuals raised only $130 million, a small fraction of tax-preferred income. Moreover, the existing minimum tax is largely a tax on only one type of preferred income—the excluded half of long-term capital gains, which constitutes about seven-eighths of the income in the minimum tax base.

The committee amendment is designed to raise the effective rate of the minimum tax on individual's tax-preferred income. It raises the minimum tax rate and reduces the overly generous exemption. Also, new tax preferences are added to the minimum tax base.

Several of these new tax preferences deal with "tax shelters." These are investments which permit persons to claim deductions that under a precise definition of income would be claimed in later years. These accelerated deductions enable the investor to deduct a loss against his ordinary income. Generally, the use of accelerated deductions in one year means that in future years the investor will have to reduce his deductions, but he still receives the benefit of tax deferral—equivalent to an interest-free loan from the Federal Government—and his tax rate may be lower in that future year than in the year in which he claimed the accelerated deductions. In some cases, it is also possible to use accelerated deductions to convert ordinary income into capital gains; this is dealt with under the recapture provisions in title II of the committee amendment.

Tax shelters create several problems. By enabling high-income individuals to avoid tax, they impair the equity of the tax system. Also, in some cases investments are undertaken not because of their economic merits but because of the tax savings they generate.

Many so-called tax shelter investments, however, do have economic merit, and elimination of the tax benefits for such investments could cause a significant decline in economic activity. This is especially true of two extremely risky industries—real estate and oil and gas drilling. In both of these industries, the committee concluded it would be undesirable to make tax changes that would cause major declines in investment. Housing construction is well below the rates achieved in 1972 and 1973, and the nation is far short of achieving the housing goals established by Congress in 1968. Oil and gas drilling is also not proceeding at a sufficiently high rate to achieve our goal of energy independence.

The House, in its bill, focused on the abuses of tax shelters and adopted a provision—the "Limitation on Artificial Losses" (LAL)—which would have eliminated much of the investment in these industries. LAL would also significantly complicate the tax system, requiring large amounts of recordkeeping by taxpayers.

The committee rejected the House approach and decided instead to deal with tax shelters through changes in the minimum tax, through the maximum tax changes described below, and through specific tax shelter provisions in title II that are designed to curb tax shelter abuses without interfering with economically meritorious investments. This approach is simpler than that of the House bill and will avoid the adverse economic impact that would have resulted from the House bill.

Explanation of provision

The committee amendment raises the minimum tax rate from 10 percent to 15 percent. In place of the existing $30,000 exemption and the deduction for regular tax liability, the amendment allows an exemption equal to $5,000 or regular tax liability, whichever is greater. (For married couples who file separate returns, the $5,000 figure is reduced to $2,500.) The existing provision that permits a carryover of unused regular tax liability is repealed. The purpose of these changes is to increase the effective rate of the minimum tax as a percentage of tax preferred income.

The committee amendment makes no change in the minimum tax for corporations generally except to delete one minor tax preference. The changes for individuals, however, apply to estates, trusts and personal holding companies.

The House bill raised the minimum tax rate only to 14 percent and contained a $20,000 vanishing exemption. It also repealed the deduction for regular tax liability. The committee believes it is appropriate to retain the deduction for regular taxes, so that the minimum tax is focused on people with relatively little regular tax liability, but to raise approximately the same amount of revenue by lowering the exemption and raising the tax rate.

The committee amendment adds the following new tax preferences to the minimum tax base: construction period interest, accelerated intangible drilling costs, the excess of investment interest over investment income, the excess of itemized deductions (other than medical expenses and casualty losses) over 60 percent of adjusted gross income, and accelerated depreciation on all leased personal property.[4]

Construction period interest.—Interest during the construction period of a building is to be treated as a tax preference under the minimum tax. "Construction period interest" is interest paid or accrued on indebtedness incurred (or continued) to purchase or carry real property to the extent the interest is attributable to the construction period for the property and is allowed as a deduction for the taxable year.

[4] Present law treats as a tax preference the accelerated depreciation on personal property subject to a net lease.

Thus, interest paid with respect to a purchase-money mortgage or other indebtedness incurred to purchase or carry unimproved land is not construction period interest to the extent that it is attributable to periods before the land begins to be used for construction.

If a taxpayer elects to capitalize construction period interest, then such interest increases the basis of the property. The interest paid or accrued in this case, will not be a preference item at that time. To the extent that the capitalized interest becomes part of the basis of the property on which accelerated depreciation is claimed in a subsequent year, however, it increases the tax preference item for accelerated depreciation in the later year.

The construction period begins with the date on which construction, reconstruction, or erection of a building starts and ends when the building or other improvement is ready to be placed in service or to be held for sale.[5] Generally, the construction period is determined separately for each building in a construction project. (A special transitional rule for low-income housing is described below.)

Accelerated depreciation on leased personal property.—Under existing law, there is a tax preference under the minimum tax for accelerated depreciation on personal property subject to a net lease. This does not include the "bonus" first-year depreciation allowance or the additional depreciation resulting from use of the Asset Depreciation Range (ADR) system. The committee amendment expands this preference, making it apply to accelerated depreciation on personal property subject to any kind of lease.

Intangible drilling expenses in excess of related income.—The committee amendment also adds an item of tax preference for accelerated intangible drilling expenses on oil and gas wells in excess of related income. For this purpose, accelerated intangible drilling expenses are those in excess of expenses which could have been deducted had the intangibles been capitalized and either deducted over the life of the well as cost depletion (regardless of whether the taxpayer actually used cost depletion in computing his regular income tax) or deducted ratably over ten years. In computing their accelerated intangible drilling costs, taxpayers may choose whichever of these two methods of capitalization is most favorable to them. The preference for accelerated intangible drilling expenses does not apply to taxpayers who elect to capitalize these costs, nor does it apply to nonproductive wells. Nonproductive wells are those that are not capable of producing oil and gas in commercial quantities. In some cases, it may be impossible to determine whether a well is productive until after the tax return is filed; thus, it may be necessary in these cases for the taxpayer to pay the minimum tax and, if the well subsequently proves to be dry, file an amended return and claim a refund.

Related income from oil and gas, which reduces the amount of intangible drilling costs included in the minimum tax base, includes gross income from oil and gas production (as defined for purposes of computing the deduction for percentage depletion) less deductions

[5] Where a portion of the building is rented prior to the completion of the entire building, property is not ready to be placed in service until the building is substantially completed within the meaning of the regulations under section 167. Property is not ready to be held for sale until it could be placed in service by the purchaser.

other than the deduction for accelerated intangible drilling expenses. (Related income is computed by deducting nonaccelerated intangible drilling costs; that is, the amount that could have been deducted had the costs been capitalized and either deducted ratably over ten years or under any method used to compute cost depletion.) Deductions for this purpose include percentage depletion (if it exceeds cost depletion) and the deduction for long-term capital gains on oil and gas wells, but they do not include net operating loss deductions or capital loss carryforwards or carrybacks. Deductions in computing related income also include those related to nonproductive wells.

Excess investment interest.—Another new tax preference added to the minimum tax by the committee amendment is excess investment interest. Generally, this is the same item of tax preference that was in the minimum tax base for the period 1970–1971. It equals the excess of investment interest over investment income. The committee amendment repeals the existing limitation on a portion of excess investment interest (sec. 163(d)), which has proved less effective in limiting this deduction than would including it in the minimum tax.

The committee amendment would not allow taxpayers who have carryovers of investment interest disallowed in prior years under section 163(d) to take an immediate deduction for such interest. For purposes of these carryovers, section 163(d) should be treated as still in effect. Taxpayers will be allowed a deduction for such interest only to the extent that they would be allowed a deduction under section 163(d).

The committee amendment makes only two changes in the earlier minimum tax provision. First, there is a transitional rule for subsidized low income housing. Second, in the case of limited partners, for purposes of computing this preference item (but not for other purposes) all interest incurred by the partnership and allocated to the limited partner is to be treated as investment interest, and all partnership income allocated to him is to be considered investment income. Thus, if a limited partner is allocated $25 of gross income from a partnership and $20 of expenses, including $10 of interest expenses, his excess investment interest under the minimum tax will be increased by $5 (the $10 interest from the limited partnership minus the $5 of partnership income). Investment interest for this purpose does not include construction period interest which is made an item of tax preference elsewhere in the bill.

Itemized deductions.—The other new tax preference added by the committee amendment is for itemized deductions (other than excess investment or construction period interest that is already a tax preference and other than deductible medical expenses and casualty losses) to the extent they exceed 60 percent of adjusted gross income. The committee has included this tax preference to prevent high-income people from using itemized deductions to avoid all tax liability. For trusts and estates, however, additional deductions are exempted from this provision. They are the distribution deduction, the net operating loss deduction, the deduction for administrative expenses and the deductions for depletion, depreciation and amortization.

Transitional rule for low-income housing.—Under the committee's amendment, special transitional rules are provided for construction period interest and excess investment interest in the case of certain subsidized low-income housing. Construction period interest paid or accrued before January 1, 1982, on such housing is excluded from the minimum tax base. In the case of excess investment interest, if construction of the low-income housing was begun before January 1, 1976, excess investment interest will be included in the minimum tax base only if such interest would have been treated as investment interest under the provisions of section 163(d) in effect before repeal by the committee amendment, and only one-half of such interest paid or accrued before January 1, 1982, will be included in the minimum tax. Where construction is begun after December 31, 1975, one-half of the excess investment interest paid or accrued after such date and before January 1, 1982, shall be included in the minimum tax base if such interest would be treated as investment interest under the new definition of investment interest provided by the committee amendment. In the case of interest paid or accrued after December 31, 1981, the entire amount of excess investment interest paid or accrued after such date will be included in the minimum tax base under the new definition of investment interest, except for interest that would not have been investment interest under section 163(d) in the case of buildings whose construction began before January 1, 1976.

Deleted preferences.—To simplify the minimum tax, several tax preferences that very few people use are deleted from the minimum tax base by the committee amendment. These are rapid amortization on child-care and on-the-job training facilities, and rapid amortization on pollution control facilties. The preference for rapid amortization for child care and on-the-job training facilities is deleted for corporations as well.

The House bill added a somewhat different set of new preferences to the minimum tax base. These were construction period interest and taxes, accelerated intangible drilling costs on productive oil and gas wells, accelerated depreciation on all leased personal property (including the acceleration that results from ADR and the "bonus" first-year depreciation allowance), depreciation on player contracts sold in connection with a snorts franchise, and itemized deductions in excess of 70 percent of adjusted gross income.

Tax benefit rule.—There are certain cases under present law in which a person derives no tax benefit from a tax preference. For example, if an individual has no adjusted gross income because of deductions for accelerated depreciation on real property (an item of tax preference under the minimum tax) and also has itemized deductions (which under these circumstances he is unable to use), the tax benefit from the accelerated depreciation deductions mav be reduced or eliminated because of the unused itemized deductions. However, the individual may still be subject to the minimum tax on the accelerated depreciation. Similar problems can occur in the case of deductions for percentage depletion, the capital gains deduction, rapid amortization and intangible drilling expenses. To some extent, the Internal Revenue Service has been able to deal with this issue through regulations. To deal with this problem specifically, the amendment instructs the Secretary of the Treasury to prescribe regulations under which items of tax preference (of both individuals and corporations) are to be properly adjusted when the taxpayer does not derive any tax benefit from the preference. For this purpose, a tax benefit includes tax deferral even if only for one year. The committee, by adding this provision, does not intend to make any judgment about the authority of the Treasury to issue these regulations under existing law.

Under existing law, the minimum tax is not imposed on tax preferences that make up a net operating loss that is carried forward to a succeeding taxable year. Instead, the minimum tax is imposed on those preferences when the net operating loss reduces taxable income. For preferences from taxable years prior to January 1, 1976, this tax rate will continue at 10 percent even if the net operating loss is deducted in a taxable year beginning after December 31, 1975. For preferences for taxable years beginning after December 31, 1975, the tax rate will be 15 percent. Thus, the year of the preferences, not the year when the net operating loss is deducted, is to determine whether the 10-percent or the 15-percent rate applies.

The above provision is the same as in the House bill.

Effective date

The amendments to the minimum tax are to apply to tax preferences for taxable years beginning after December 31, 1975. Carryovers of unused regular inome tax from prior years are not to be allowed to offset tax preferences in these taxable years.

Revenue effect

This provision will increase budget receipts by $980 million in fiscal year 1977, $1,077 million in fiscal year 1978, and $1,437 million in fiscal year 1981.

2. Maximum tax rate (sec. 302 of the amendment and sec. 1348 of the Code)

Present law

Under existing law, the maximum marginal tax rate on taxable income from personal services is limited to 50 percent. For this purpose, income from personal services (in the past this was referred to as "earned income") includes wages, salaries, professional fees or compensation for personal services (including royalty payments to authors or inventors) and, for an individual engaged in a trade or business where both personal services and capital are material income-producing factors, a reasonable amount (not to exceed 30 percent) of his share of the net profits from the business. Personal service income for this purpose does not include deferred compensation, penalty distributions from owner-employee plans, lump-sum distributions from pension plans or distributions from employee annuity plans.

The amount of personal service income eligible for the 50-percent maximum tax is reduced in three ways. First, it is reduced by trade or business deductions allowable under section 62 (which excludes most trade or business deductions of employees) properly allocable to personal service income. Second, it is reduced by a pro rata share of deductions from adjusted gross income used in computing taxable income (including all itemized deductions, the standard deduction and the deduction for personal exemptions). Third, it is reduced by the taxpayer's items of tax preference (as defined under the minimum tax) or the average of the taxpayer's tax preferences over the current year and the four preceding years, whichever is greater, in excess of $30,000.

For married couples, the maximum tax only applies if they file a joint return, and taxpayers cannot use the maximum tax if they use income averaging.

Reasons for change

The committee believes that many of the problems of our tax system result from the high nominal tax rates in the upper brackets. The government collects relatively little tax from the brackets above 50 percent; indeed, limiting the top bracket rate to 50 percent for all income would only reduce revenues by about $2 billion. Yet the existence of the high tax brackets discourages saving by high-income people and encourages them to find ways to shelter their income tax, which in turn tends to undermine the whole voluntary system of self-assessment underlying our tax system. Moreover, the search for tax-avoidance devices often absorbs energy and talent that could better be used elsewhere in the economy.

In 1969, Congress enacted a 50-percent maximum marginal tax rate on what is now called personal service income. This provision was intended to serve two purposes—to encourage work effort and to discourage use of tax preferences. The latter purpose was intended to be achieved in two ways: by the limit on the maximum marginal tax rate on personal service income to 50 percent, which is the tax bracket at which it begins to be worthwhile for taxpayers to invest in tax shelters, and by the so-called "preference offset," whereby tax preferences directly raise the tax rate on earned income by reducing the portion of personal service income eligible for the 50 percent maximum rate.

Unfortunately, the maximum tax has not been as effective in discouraging use of tax preferences as was expected in 1969. This lack of success is a result of several characteristics of the existing maximum tax. First, personal service income is "stacked" below other income in computing what income is taxed at the bottom brackets. Thus, for a married couple filing a joint return, personal service taxable income must be over $52,000 before there is any benefit at all from the maximum tax, and it must be over $200,000 before the 70-percent bracket is reached and the maximum benefit is derived from the maximum tax. Many people with a substantial amount of personal service income have significant amounts of investment income, and often this makes the maximum tax for these persons less important. As a result in their case there still remains an incentive to shelter income from tax. Second, the "preference offset" is rendered ineffective by the $30,000 exemption and the failure to include enough preferences in the base.

The committee amendment makes changes in the maximum tax which will make it an effective deterrent to the use of tax shelters for many taxpayers and will reduce the adverse economic effects of the existing high rate brackets. These changes are also equitable because they reduce the tax burden for a group that is paying more than its fair share.

Explanation of provision

The committee amendment expands the definition of income eligible for the 50-percent maximum marginal tax rate to include a limited amount of net investment income. For this purpose, investment income is defined as all income other than personal services incomes, other than certain types of pension income specifically excluded from the definition of personal services income and other than long-term capital gains (in excess of short-term capital losses). Net investment income equals investment income less any trade or business deductions (under sec. 62) properly allocable to investment income. The amount of net investment income eligible for the maximum rate is limited to the lesser of (a) $100,000 or (b) personal service net income.

As under present law, income eligible for the maximum rate is reduced by a *pro rata* share of deductions from adjusted gross income used in computing taxable income.

The committee amendment also provides that the definition of personal service income eligible for the maximum tax includes pensions or annuities and deferred compensation. However, lump-sum distributions and penalty distributions are ineligible for the maximum tax. Personal service net income equals this broadened amount of personal service income less section 62 deductions properly allocable to this income and less all of the taxpayer's items of tax preference.

The committee amendment modifies the preference offset by eliminating the $30,000 exemption. Also, it eliminates the alternative preference offset of a 5-year average of preferences, which is no longer necessary with repeal of the exemption. The list of tax preferences is changed to include the same items that are in the base of the minimum tax for individuals. These changes should make the preference offset a strong deterrent to the use of tax preferences.

As an example of how this new maximum tax will work, consider an individual with a salary of $200,000, dividends of $50,000, a long-term capital gain of $50,000, and deductions of $30,000. Under existing law, adjusted gross income is $275,000 and taxable income is $245,000. There is no preference offset under the maximum tax because the $25,000 excluded part of the capital gain is less than the $30,000 exemption. Earned net income elibigle for the maximum tax is $200,000; and earned taxable income (i.e., earned net income reduced bv the earned income's *pro rata* share of the $30,000 deductions) in $178,181.80. The tax benefit from the maximum tax for a married couple filing a joint return is $13,792.

Under the committee amendment, personal services income eligible for the maximum tax would be $175,000 and eligible investment income would be $50,000. a total of $225,000. The reduction for this incomes' *pro rata* share of deductions would reduce taxable income eligible for the maximum tax to $200,454.50. The tax benefit from the maximum tax would be $19,011.

Effective date

The changes in the maximum tax are to apply to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $49 million in fiscal year 1977, $333 million in fiscal year 1978, and $577 million in fiscal year 1981.

D. EXTENSION OF INDIVIDUAL INCOME TAX REDUCTONS

(Sec 401–402 of the Bill and Secs. 42, 43, and 141 of the Code)

Present law

The Revenue Adjustment Act of 1975 (P.L. 94–164) enacted three individual income tax cuts for the first six months of 1976. These were an increase in the standard deduction, a general per person tax credit and an earned income credit.

Prior to the 1975 tax reduction, the minimum standard deduction (or low-income allowance) was $1,300. The Tax Reduction Act of 1975 (P.L. 94–12) increased it to $1,600 for single returns and to $1,900 for joint returns for the year 1975. The tax reduction in the Revenue Adjustment Act of 1975, on a full-year basis, would increase the minimum standard deduction to $1,700 for single returns and to $2,100 for joint returns.

The percentage standard deduction was 15 percent prior to 1975. The Tax Reduction Act of 1975 and the Revenue Adjustment Act increased it to 16 percent for the years 1975 and 1976, respectively.

The maximum standard deduction was $2,000 before 1975. The Tax Reduction Act of 1975 increased it to $2,300 for single returns and to $2,600 for joint returns for 1975. On a full-year basis, the Revenue Adjustment Act of 1975 would increase it to $2,400 for single returns and to $2,800 for joint returns for 1976.

The Tax Reduction Act of 1975 also provided a nonrefundable credit of $30 for each taxpayer and dependent for 1975. The Revenue Adjustment Act of 1975, on a full-year basis, would increase this credit to the greater of $35 per capita or 2 percent of the first $9,000 of taxable income.

In addition, the Tax Reduction Act of 1975 included a refundable tax credit equal to 10 percent of the first $4,000 of earned income, phased out as adjusted gross income rises from $4,000 to $8,000. This earned income credit applies only to families who maintain a household for at least one dependent child for whom they are entitled to claim a personal exemption. The earned income credit was extended for the first six months of 1976 in the Revenue Adjustment Act of 1975. Also, the credit for 1975 was modified to provide that it be disregarded in determining eligibility for, or benefits under, Federal or federally-assisted aid programs, as long as the individual is a recipient of benefits under the program in the month before he receives his tax refund under the earned income credit.

The Tax Reduction Act of 1975 provided that the changes in the standard deduction and the general tax credit be reflected in lower withheld and estimated taxes for the last eight months of 1975. The

Revenue Adjustment Act of 1975 extended those same withholding rates and estimated tax requirements through June 30, 1976.

The Revenue Adjustment Act of 1975 reduced taxes only for the first half of 1976. This was achieved by enacting a reduction in tax liability approximately equal to one-half of the full-year reduction described above and by providing that this tax cut be entirely reflected in lower withheld and estimated tax payments in the first six months of 1976.[1]

Unless there is an extension of the tax cuts for the rest of 1976, it is the half-year version of the tax reduction that will apply for 1976, and withholding rates will rise on July 1, 1976, to the rates that prevailed before the 1975 tax cuts.

Reasons for change

Without new legislation, income tax withholding rates will rise by $13 billion on July 1, 1976. The committee believes that economic conditions do not warrant this tax increase. While the recovery from the 1974–75 recession has proceeded far enough that we have now reached the level of output that existed prior to the recession at the end of 1973, there is still a large gap between what the economy is capable of producing and what it actually produces. The unemployment rate was 7.3 percent for May 1976, compared to its pre-recession level of less than 5 percent, and capacity utilization in manufacturing is only 72 percent, compared to 83 percent in 1973.

An extension of the expiring 1975 income tax cuts at least through the next 12 months, through the first half of 1977, is needed to permit a continuation of the current economic recovery. This extension does not provide any new fiscal stimulus to the economy; it only prevents the withdrawal of existing stimulus. In early 1977, the committee plans to review the economic situation to see if a further income tax cut extension is appropriate.

The tax cuts also serve purposes other than economic stimulus. The increase in the standard deduction represents a major simplification of the tax law because it will encourage taxpayers who file over 9 million tax returns to switch from itemizing their deduction to using the standard deduction. Also, the increase in the standard deduction creates greater equity between users of the standard deduction and itemizers, since itemized deductions have risen in recent years as a result of inflation while there has been no comparable increase allowed in the standard deduction. For these reasons, the committee believes the increases in the standard deduction should be made permanent.

The income tax cuts also will raise the income level at which people begin to pay income taxes (the tax threshold) above the current

[1] For the minimum standard deduction, the half-year tax cut for 1976 involves an increase from $1,300 to $1,500 for single returns and to $1,700 for joint returns (compared with increases to $1,700 and $2,100 respectively in the full-year version of the tax cuts). The maximum standard deduction was increased in the half-year version from $2,000 to $2,200 for single returns and to $2,400 for joint returns (compared with increases to $2,400 and $2,800 respectively in the full-year version). The percentage standard deduction was increased from 15 percent to 16 percent in the half-year version, which is the same level as in the full-year version.

For the general per person tax credit, the half-year variant is a credit equal to the greater of $17.50 per capita or one percent of the initial $9,000 of taxable income (compared with a credit equal to the greater of $35 per capita or 2 percent of the first $9,000 of taxable income in the full-year version).

For the earned income credit, the half-year version is 5 percent of the initial $4,000 of earnings (compared with a 10-percent rate on the full-year version) with the same income phaseout as mentioned above.

poverty level. If taxes were allowed to rise on June 30, the income tax threshold would fall substantially below the poverty level. This is shown in Table 1, which compares the poverty level in 1976 with the income tax threshold with and without the tax cuts. If the tax cuts expire, the poverty level will be $1,550 above the threshold for a family of four, which means that such a family could be liable for a Federal income tax burden as high as $222.

TABLE 1.—POVERTY LEVELS AND FEDERAL INCOME TAX THRESHOLDS, 1976

	1976 poverty level	Income tax threshold	
		Without tax cuts [1]	With tax cuts [2]
Family size:			
1	$2,970	$2,050	$2,700
2	3,840	2,800	4,100
3	4,570	3,550	5,100
4	5,850	4,300	6,100
5	6,900	5,050	7,083
6	7,770	5,800	8,067

[1] Personal exemption of $750 and minimum standard deduction of $1,300.

[2] Personal exemption of $750, minimum standard deduction of $1,700 for single returns and $2,100 for joint returns, and $35 tax credit for each taxpayer and dependent.

The committee also decided to make the earned income credit a permanent feature of the personal income tax. This provides needed tax relief to a hard-pressed group in the population—the lower income worker. It also provides a strong work incentive, since the credit is based on the amount of earned income. In effect, it offsets the social security payroll taxes payable with respect to those who are working but whose incomes are slightly, if any, above the levels of those on welfare. This is designed to improve the financial position of those who work relative to those remaining on welfare.

Explanation of provisions

The committee amendment makes permanent the full-year increases in the standard deduction provided by the Revenue Adjustment Act of 1975. The amendment increases the minimum standard deduction from $1,300 to $1,700 for single returns and to $2,100 for joint returns, and increases the percentage standard deduction from 15 percent to 16 percent. The amendment also raises the maximum standard deduction from $2,000 to $2,400 for single returns and $2,800 for joint returns. For this purpose, the reference to joint returns is intended to include returns of surviving spouses who are entitled to use the rate schedule applicable to married couples who file joint returns. Similarly, the reference to single returns is intended to include heads of households. For married couples who file separate returns, the minimum standard deduction is raised from $650 to $1,050, and the maximum standard deduction is raised from $1,000 to $1,400.

The House bill would have made permanent the somewhat smaller increases in the standard deduction enacted for 1975 in the Tax Reduction Act of 1975.

The committee amendment also makes permanent the earned income credit. This is a refundable tax credit equal to 10 percent of the first

$4,000 of earnings, phased out as adjusted gross income rises from $4,000 to $8,000. It is available only for those who maintain a household for a dependent child, as under present law. The amendment also provides that the refunds resulting from this credit should be disregarded in determining eligibility for or benefits under Federal or Federally-assisted aid programs in the case of people who are recipients of benefits under the program in the month before they receive their refund. A similar provision is in the law applying to the 1975 credit. Also, the amendment eliminates the requirement that a parent must be entitled to a personal exemption for at least one child in order to claim the earned income credit. Instead, there is a requirement that the parent simply maintain a household for a child who is either under 19 or a student.

The House bill did not include an extension of the earned income credit, but did contain a disregard provision for the 1975 credit similar to the one in the committee amendment.

The committee amendment also extends the general per person tax credit until June 30, 1977. For 1976, this involves enacting the full-year version of the credit for 1976 in place of the half-year version of the credit in the Revenue Adjustment Act of 1975.[2] This credit is the greater of $35 per taxpayer and dependent or 2 percent of the first $9,000 of taxable income. To provide a half-year extension of the credit for 1977, the committee amendment includes a credit for that year equal to the greater of $17.50 per taxpayer and dependent or one percent of the first $9,000 of taxable income.

The House bill would have included a tax credit of 2 percent of the first $12,000 of taxable income, applying only to 1976.

The committee amendment also requires the Internal Revenue Service to continue until June 30, 1977, to use the withholding rates in effect since the enactment of the Tax Reduction Act of 1975. Declarations of estimated tax payments in 1977, insofar as they relates to payments made in the first half of the year, are to be made on the assumption that the provisions in effect for the first half of the year continue in effect for the entire year. After June 30, 1977 (if no change is made in subsequent action by Congress), the Service is to issue new withholding tables that are the same as the pre-1975 tables except to reflect the changes in the standard deduction made by the committee amendment.

The committee amendment also permanently raises the income tax filing requirement to reflect the increases in the minimum standard deduction.

Effective date

The changes in the standard deduction and the earned income credit apply to taxable years ending after December 31, 1975. The full-year version of the general per person tax credit applies to taxable years ending after December 31, 1975, and before January 1, 1977. The half-year variant of the per person credit applies to taxable years ending after December 31, 1976, and before January 1, 1978.

[2] The greater of $17.50 per taxpayer and dependent or one percent of the first $9,000 of taxable income.

Revenue effect

The changes in the standard deduction will reduce tax liability by $2.2 billion in calendar year 1976 and $4.1 billion in 1977. The general per person tax credit involves a revenue loss of $4.6 billion in 1976 and $5.0 billion in 1977. The earned income credit involves a revenue reduction of $1.3 billion in 1977.

The extension of the individual tax cuts provided in the committee amendment will reduce income tax receipts in fiscal year 1977 by $12.5 billion, of which $4.1 billion is attributable to the standard deduction, $7.6 billion to the general per person credit, and $0.7 billion to the earned income credit.

E. TAX SIMPLIFICATION IN THE INDIVIDUAL INCOME TAX

1. Revision of Tax Tables for Individuals (sec. 501 of the bill and secs. 3, 4, 36, 144, 1211, 1304 and 6014 of the Code)

Present law

Under present law, a taxpayer whose adjusted gross income is under $10,000 ($15,000 for 1975 only) and who takes the standard deduction is required to use the optional tax tables. These tables have AGI brackets as horizontal row designations; marital status and number of exemptions as vertical column headings; and the amount of tax in the resulting cell. A taxpayer whose income is greater than $10,000 ($15,000 for 1975 only) or who itemizes his deductions must compute his tax using the tax rates.

Reasons for change

The optional tax table set-up which provides a different table for each number of exemptions claimed by the taxpayer just to cover up to $10,000 of AGI has resulted in 6 pages of fine print, representing 12 optional tax tables in the instructions accompanying the income tax return. The 1975 tables extending up to $15,000 of AGI cover 10 pages in the instructions. In addition, a separate publication is required for taxpayers claiming 13 or more exemptions. This system has been a considerable source of taxpayer error since taxpayers are not always sure which table to use or, because of the necessarily small size of the print, which is the proper tax figure to enter on their return. In the interest of taxpayer compliance and simplification of the instructions as well as increased accuracy in the determination of the proper tax by taxpayers, the committee believes it is desirable to eliminate the existing optional tax table system and to adopt a table based on taxable income. This should make it possible to print the tax table on two pages.

Explanation of provision

The committee amendment revises the existing optional tax tables by providing that taxpayers with taxable incomes of $20,000 or less are to use a tax table based on taxable income which is to be prescribed by the Secretary of the Treasury on the basis of the existing tax rates. This table is to be used by individuals, estates, and trusts. The House bill provision is identical to the committee amendment.

In constructing such a taxable income table, the Secretary has the authority to design a bracket system analogous to that in the existing optional tax table. In order to limit the taxable income bracket table to two pages and to have the tax table run to $20,000 of taxable income, the tax liability of an individual may have to be several dollars higher at the bottom of one bracket than at the top of the next lower bracket. (This is presently the case with the existing optional tax table.) However, the amount involved is only a small portion of the existing tax. This change is necessary to achieve the simplification and taxpayer accuracy that is generally believed to be desirable.

In order to use the tax table, the taxpayer must subtract from his adjusted gross income the amount of his personal exemptions and itemized deductions or standard deduction (either percentage or minimum standard deduction). This will entail additional computations for some taxpayers but should, on balance, result in improved taxpayer compliance and greater accuracy than is achieved under the existing system. (It is estimated that over 90 percent of taxpayers will use the new tables.)

In the case of a taxpayer with a short taxable year, the taxpayer still is to annualize his income as he does under section 443 (b).

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will not have any revenue effect.

2. $50 Floor on Individual Deduction of State and Local Taxes on Gasoline (sec. 502 of the bill and sec. 164 of the Code)

Present law

Under present law, a taxpayer who itemizes his deductions may deduct State and local taxes paid by him for the purchase of gasoline, diesel fuel, and other motor fuels. In practice, the amount of this deduction may be computed either from a record of taxes actually paid by the taxpayer on his gasoline or the amount provided in the gasoline tax tables provided by the Internal Revenue Service. These tables are based on a taxpayer's calculation of the mileage he drove during the year, the size of his car and the gasoline tax rates in each State.

Reasons for change

The committee believes that the gasoline tax deduction involves complications disproportionate to any benefit for most taxpayers. Not only is there much guessing in the gasoline tax calculation but the amount of tax savings for the average taxpayer is generally small. (For example, where a taxpayer and his family drove as much as 20,000 nonbusiness miles in a year, the tax saving would be only about $25 in most States if the taxpayer is in the 25-percent bracket.)

In addition, State and local gasoline taxes, like the nondeductible Federal gasoline tax, can be viewed essentially as charges by a State for the use of its highways. Therefore, they seem more like a personal expense for automobile travel (such as tolls) than a tax. Deductibility in this sense is inconsistent with the user charge character of the tax in that it serves to shift part of the cost from the highway user to the general taxpayer. The tax can be a burden, however, for taxpayers who have significant commuting distances. Balancing these considerations, the committee concluded that only those payments for State and local gasoline taxes which constitute significant amounts should be deductible. As a result, the committee believes it is appropriate to limit the deduction to amounts in excess of $50. Moreover, limiting the deduction to amounts in excess of $50 will cause many taxpayers to switch to the standard deduction, thereby simplifying tax administration.

Explanation of provision

The committee amendment places a $50 floor on the deduction for State and local taxes paid by a taxpayer for the purchase of gasoline, diesel fuel and other motor fuels for nonbusiness use. (The business expense deduction for gasoline, etc., including the tax, still remains available). Thus, only amounts paid for such gasoline taxes in excess of $50 per year will be deductible. The House bill did not contain a comparable provision.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $285 million in fiscal year 1977, $287 million in fiscal year 1978, and $343 million in fiscal year 1981.

3. Alimony Payments (sec. 503 of the bill and secs. 62 and 3402(m)(2) of the Code)

Present law

Under present law, a deduction for alimony may be taken as an itemized deduction from adjusted gross income in the year paid in arriving at taxable income. The recipient of alimony must include such payments in his or her income and pay tax on them. Payments for the support of a spouse which are not required by a divorce or separation agreement and payments for the support of children are considered normal living expenditures on the part of a taxpayer. Such expenditures are not deductible and are not included in the income of the recipients.

Reasons for change

The committee believes that the splitting of income or assignment of income through the payment of alimony is not properly treated under current law which permits only an itemized deduction for alimony. Instead, the committee believes it is more appropriate to take the payment of alimony into account as a deduction in arriving at adjusted gross income, rather than as itemized deductions which are generally limited to personal expenses. As a deduction from gross income, the alimony deduction would be available to taxpayers who elect the standard deduction as well as to those taxpayers who elect to itemize their deductions.

Explanation of provision

The committee amendment takes the payment of alimony into account in determining adjusted gross income, in the same manner provided in the House bill.

The committee amendment moves the deduction of alimony payments from an itemized deduction to a deduction from gross income to arrive at adjusted gross income (sec. 62). The amendment also makes a conforming change in the section providing a withholding allowance for itemized deductions (sec. 3402(m)(2)). This change includes the deduction for alimony as one of the deductions taken into account for determining withholding allowances in order to avoid overwithholding. Previously such allowances, which are based on estimated itemized deductions, could not take alimony into account.

Effective date

This provision is to apply to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $7 million in fiscal year 1977, $44 million in fiscal year 1978, and $59 million in fiscal year 1981.

4. Retirement Income Credit (sec. 504 of the amendment and sec. 37 of the Code)

Present law

Under present law, individuals who are 65 years of age or over may receive a tax credit based on the first $1,524 of retirement income. The credit is 15 percent of this retirement income. Each spouse who is 65 or over may compute his tax credit on up to $1,524 of his own retirement income (whether the couple files separate or joint returns). Alternatively, spouses 65 or over who file joint returns may compute their credit on up to $2,286 of retirement income (one and one-half times $1,524) even though one spouse received the entire amount of the retirement income.

To be eligible for the credit an individual must have received more than $600 of earned income in each of the prior 10 years. (A widow or widower whose spouse had received such earned income is considered to have met this earned income test).

Retirement income, for purposes of this credit, includes taxable pensions and annuities, interest, rents, dividends, and interest on Government bonds issued especially for the self-employed setting aside amounts under "H.R. 10" retirement-type plans.

The maximum amount of retirement income which an individual may claim ($1,524, or $2,286 for certain married couples) must be reduced by two broad categories of receipts. First, it must be reduced on a dollar-for-dollar basis by the amount of social security, railroad retirement, or other exempt pension income received by the taxpayer. Second, the maximum amount of retirement income eligible for the credit is further reduced by one-half of the annual amount of earned income over $1,200 and under $1,700 and by the entire amount of earned income in excess of $1,700. This reduction for earned income does not apply to individuals who have reached age 72.

Individuals under age 65 also are eligible for tax credits for retirement income but only with respect to pensions received under a public retirement system. Only income from a pension, annuity, retirement, or similar fund or system established by the United States, a State, or a local government, qualifies under this provision. This restriction of retirement income for purposes of the credit to income from a public retirement system applies only until the individual reaches the age of 65; thereafter he is entitled to take the credit on the same basis as other individuals who have reached that age.

Reasons for change

There is a need to redesign the present retirement income credit for several basic reasons. One reason is that the credit needs updating. Most of the features of the present credit have not been revised since 1962 when the maximum level of income on which the credit is computed was set and when the current earnings limits were established.[1] Since then, there have been numerous revisions of the social security law which substantially liberalized the social security benefits. As a result, the present maximum amount of income eligible for the credit is considerably below the average annual social security primary benefit received by a retired worker and the average social security primary and supplementary benefit that could be received by a retired worker and spouse (one and one-half times the primary benefit).

In addition, the complexity of the present retirement income credit prevents it from providing the full measure of relief it was intended to grant to elderly people. This complexity stems from an attempt to pattern the credit after the social security law. For example, to claim the credit on his tax return, a taxpayer must show that he has met the test of earning $600 a year for 10 years; he must also segregate his retirement income from his other income; he must reduce the maximum amount of retirement income eligible for the credit by the amount of his social security income and by specified portions of his earned income under the work test; a credit of one-half times the basic credit is available for a man and his wife; and a credit is available

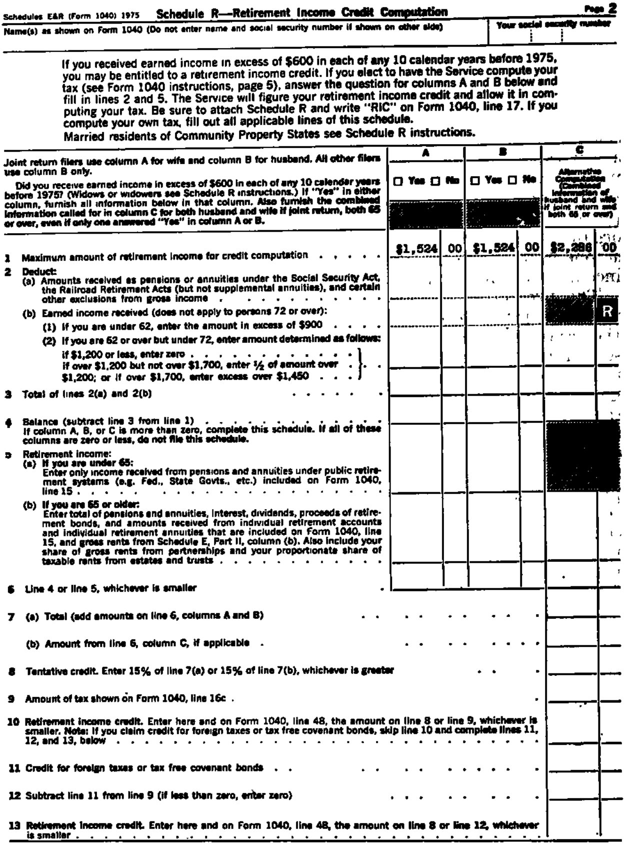
[1] One other feature of the credit was adopted in the 1964 Revenue Act. This provision allowed spouses 65 and over who file joint returns to claim a credit on up to $2,286 of retirement income (one and one-half times the $1,524 maximum base for single people) even if one spouse receives the entire amount of the married couple's retirement income.

for each spouse separately if each spouse independently meets the eligibility tests.

The purpose of all these provisions is to treat taxpayers who receive little or no social security benefits on as equal a basis as possible with those who get tax-exempt social security benefits. However, the result has been to impose severe compliance burdens on large numbers of elderly people, many of whom are not skillful in filing tax returns. Such individuals must now compute their retirement income credit on a separate schedule, which occupies a full page in the tax return packet, with 19 separate items, some of which involve computations in three separate columns (see the form shown below). It is these complexities which undoubtedly account for the fact that some of the organizations representing retired people have estimated that as many as one-half of all elderly individuals eligible to use the retirement income credit do not claim this credit on their tax returns.

The present retirement income credit discriminates among individuals depending on the source of their income. As indicated above, the credit is available only to those with retirement income—that is, some form of investment or pension income. Elderly individuals who must support themselves by earning modest amounts and who have no investment or pension income are not eligible for any relief under the present credit. This has given rise to considerable criticism as to the fairness of the tax law: many elderly individuals who rely entirely on earned income maintain that they should be allowed the same retirement income credit as those who live on investment income. Under the present credit, elderly people who rely entirely on earned income are required to pay substantially higher taxes than individuals who are comparable in every respect except that they have significantly larger incomes which come from investments. Another criticism is that higher taxes on earnings than on retirement income serve as a disincentive to work.

A further problem with present law is that it discriminates among taxpayers under age 65 depending on whether they retired from public employment or private employment because the retirement income credit is available for individuals under age 65 only with respect to pensions received under a public retirement system. As a practical matter, the earnings cut back (the maximum amount of the credit is reduced dollar-for-dollar for income in excess of $600 a year) makes the provision worth little or nothing for many public employees who retire early because they tend to take other jobs, frequently on a part-time basis. Thus, it is possible to completely eliminate the existing retirement income credit and its associated complexity and do away with the existing form (Schedule R, as shown below) with a relatively small adverse impact on taxpayers. The complexity that would result from having two systems, one for those under age 65 and the other for those age 65 or over on joint returns when one spouse is under age 65 and a public retiree and the other is age 65 or over, is also avoided.



Schedules E&R (Form 1040) 1975 **Schedule R—Retirement Income Credit Computation** Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side) | Your social security number

If you received earned income in excess of $600 in each of any 10 calendar years before 1975, you may be entitled to a retirement income credit. If you elect to have the Service compute your tax (see Form 1040 instructions, page 5), answer the question for columns A and B below and fill in lines 2 and 5. The Service will figure your retirement income credit and allow it in computing your tax. Be sure to attach Schedule R and write "RIC" on Form 1040, line 17. If you compute your own tax, fill out all applicable lines of this schedule.

Married residents of Community Property States see Schedule R instructions.

	A	B	C
Joint return filers use column A for wife and column B for husband. All other filers use column B only. Did you receive earned income in excess of $600 in each of any 10 calender years before 1975? (Widows or widowers see Schedule R instructions.) If "Yes" in either column, furnish all information below in that column. Also furnish the combined information called for in column C for both husband and wife if joint return, both 65 or over, even if only one answered "Yes" in column A or B.	□ Yes □ No	□ Yes □ No	Alternative Computation (Combined information of husband and wife if joint return and both 65 or over)
1 Maximum amount of retirement income for credit computation	$1,524 00	$1,524 00	$2,286 00
2 Deduct: (a) Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities), and certain other exclusions from gross income			
(b) Earned income received (does not apply to persons 72 or over): (1) If you are under 62, enter the amount in excess of $900			R
(2) If you are 62 or over but under 72, enter amount determined as follows: if $1,200 or less, enter zero if over $1,200 but not over $1,700, enter ½ of amount over $1,200; or if over $1,700, enter excess over $1,450			
3 Total of lines 2(a) and 2(b)			
4 Balance (subtract line 3 from line 1) If column A, B, or C is more than zero, complete this schedule. If all of these columns are zero or less, do not file this schedule.			
5 Retirement income: (a) If you are under 65: Enter only income received from pensions and annuities under public retirement systems (e.g. Fed., State Govts., etc.) included on Form 1040, line 15			
(b) If you are 65 or older: Enter total of pensions and annuities, interest, dividends, proceeds of retirement bonds, and amounts received from individual retirement accounts and individual retirement annuities that are included on Form 1040, line 15, and gross rents from Schedule E, Part II, column (b). Also include your share of gross rents from partnerships and your proportionate share of taxable rents from estates and trusts			
6 Line 4 or line 5, whichever is smaller			
7 (a) Total (add amounts on line 6, columns A and B)			
(b) Amount from line 6, column C, if applicable			
8 Tentative credit. Enter 15% of line 7(a) or 15% of line 7(b), whichever is greater			
9 Amount of tax shown on Form 1040, line 16c			
10 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 9, whichever is smaller. Note: If you claim credit for foreign taxes or tax free covenant bonds, skip line 10 and complete lines 11, 12, and 13, below			
11 Credit for foreign taxes or tax free covenant bonds			
12 Subtract line 11 from line 9 (if less than zero, enter zero)			
13 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 12, whichever is smaller			

Explanation of provision

The committee amendment first updates the maximum base for the credit to $2500 for single persons age 65 or over and $3,750 for a joint return with both spouses age 65 or over (when the provision is fully effective). Then it restructures the credit, eliminating the parallel with the social security treatment, and making it available for earned income as well as retirement income. Since the credit is no longer limited to retirement income, the credit has been renamed the "credit for the elderly". To focus relief on low- and middle-income taxpayers, in view of the broadening of the credit, the maximum amounts of the base for the credit are reduced by one-half of adjusted gross income in excess of $7,500 a year for a single person and over $10,000 for joint returns with both spouses age 65 or over.

The committee amendment phases in the increase of the maximum base for the credit, raising it to $2,000 in 1976 and $2,500 in 1977 for elderly single persons and to $3,000 and $3,750, respectively, for joint returns with both spouses age 65 or over. The amendment also eliminates the present retirement income credit for public employees under age 65.

The House bill is the same as the committee amendment except that the House bill does not phase in the increase in the base for the credit (it made the increase fully applicable for 1976), and the House bill does not eliminate the retirement income credit for public retirees under age 65.

More specifically, the credit for the elderly provided by the committee amendment liberalizes the retirement income credit available under present law for those age 65 and over in four respects. First, the amount of income with respect to which the 15-percent credit may be claimed is increased to $2,500 for a single person and for a married couple filing jointly if only one spouse is 65 or over, and to $3,750 in the case of a married couple filing a joint return where both are 65 or over (when fully effective).

Second, all types of income, including earned income, are to be eligible for the credit. Third, the maximum amounts on which the credit is based are reduced by one-half of adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return ($5,000 for a married individual filing a separate return). The separate computation of the retirement income credit available to each spouse on a joint return under present law is eliminated and the new elderly credit is made available on the basis of the couple's combined income. Correspondingly, the maximum base for the credit is reduced by the total social security income received by either spouse. Because of the cutback based on the couple's combined income, the credit is available to married couples only if they file a joint return, except in the case of a husband and wife who live apart at all times during the taxable year, which is a "nonlegal" separation and indicates that filing a joint return might not be possible.

For such returns, the credit is to be available without regard to State community property laws. Otherwise, the spouse who did not receive social security income would have the maximum base for the credit reduced by one-half of such income received by the other spouse. The fact that a separate return was filed under these conditions implies that the social security income was probably not actually shared with the spouse who did not receive it initially. This rule will complicate the instructions, but will avoid an inequity that would otherwise result.

Fourth, the credit is to be available regardless of whether the individual has had work experience (i.e., has received earned income) in prior years.

Under the amendment the amount with respect to which the 15-percent credit may be claimed (referred to as the "section 37 amount") may not exceed a maximum amount (referred to as the "initial amount") of $2,500 in the case of a single individual age 65 or over or a married couple filing a joint return where only one spouse is age 65 or over. In the case of a married couple filing a joint return where both spouses are age 65 or over, the maximum amount is $3,750, and if a married individual age 65 or over files a separate return the maximum amount is $1,875. (As under present law, the age of an individual is to be determined as of the close of the taxable year in question.) This credit is to be available whether or not the individual (or his spouse in the case of a joint return) has received $600 of earned income in each of ten prior years.

The maximum amount is to be reduced by amounts received by the individual (and by his spouse in the case of a married couple filing a joint return) as a pension or annuitv under the Social Securitv Act, the Railroad Retirement Acts, or as a pension or annuity which is otherwise excluded from gross income.

An example of the tvpe of simplified tax credit form for taxpavers age 65 and over which these changes make possible is shown below. This form is less than one-third as long as the present form and involves only one column instead of three. It requires the taxpayer to select the appropriate amount on which to compute the credit and to deduct from this amount his social securitv or certain other tax-exempt income. It also requires the taxpaver to deduct adjusted gross income above specified levels. The credit is computed at a 15-percent rate on the balance, and this is then entered on the basic income tax form 1040 as a tax credit.

SCHEDULE R.—*Credit for taxpayers age 65 or over*

MAXIMUM AMOUNTS FOR CREDIT COMPUTATION [1]

If you are: (check one box):	*Then your maximum amount for credit computation is—*
□ Single	$2,500
□ Married filing jointly and only one spouse is 65 or over	2,500
□ Married filing jointly, both age 65 or over	3,750
□ Married filing a separate return and age 65 or over	1,875

1. Enter (from above) your maximum amount for credit computation ______

2. Amounts received as pensions or annuities under the Social Securit Act, the Railroad Retirement Acts (but not supplemental annuities) and certain other exclusions from gross income ______

3. Adjusted gross income reduction. Enter *one-half* of adjusted gross income (line 15 form 1040) in excess of $7,500 if single; $10,000 if married filing jointly; or $5,000 married filing separately ______

4. Total of lines 2 and 3 ______

5. Balance (subtract line 4 from line 1); if more than zero complete this form; if zero or less, do not file this form ______

6. Amount of credit; enter (here and on form 1040, line 49) 15 percent of line 5 but not more than the total income tax on form 1040, line 16 ______

[1] When fully effective.

Since the maximum amounts of the base for the credit are reduced by one-half of the adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return ($5,000 for a married taxpayer filing a separate return), for a single person the credit would no longer be available when his adjusted gross income reaches $12,500 ($7,500 plus two times $2,500). For a joint return, the credit would be available up to an income level of $15,000 if only one spouse is age 65 or over and up to $17,500 if both spouses are age 65 or over (when fully effective).

The most significant extension of the credit provided by the committee is that it will for the first time benefit low-income earners age 65 or over regardless of whether they receive retirement income or earned income. In conjunction with the minimum standard deduction of $1,700 for single persons and $2,100 for joint returns and the $35 per capita tax credit, the credit for the elderly will permit a single elderly person to receive approximately $5,700 of earned income or pension income subject to tax before becoming taxable.[2] For a joint return with both spouses age 65 or over, the tax-free income level will be almost $9,200 (again when fully effective in both cases).

The change in the retirement income credit to a tax credit for the elderly and the increase in the base for the credit will increase the number of returns with at least one taxpayer age 65 or over benefiting from about 400 thousand to about 2.4 million.

As under present law, the committee amendment provides that the credit for the elderly may not exceed the individual's (or the married couple's, in the case of a joint return) tax for the year. For this purpose, however, the bill provides that the credit for the elderly is to be taken before the foreign tax credit. In other words, the tax for the year is to be computed before reduction for the foreign tax credit. A correlative change is made by the amendment in the limitation on the foreign tax credit to reflect this reordering of the priority of these two credits. Thus, the limitation on the foreign tax credit is to be computed with respect to the tax for the year after reduction for the retirement income credit.

In addition, the credit for the elderly is available to nonresident aliens who are married to citizens or residents of the United States who agree to make records of their combined income available for inspection to the IRS (i.e., those nonresident aliens treated as residents by section 1012 of the committee amendment).

Effective date

The change in the structure of the credit and the elimination of the credit for public retirees under age 65 are to apply to taxable years beginning after December 31, 1975, as is the first stage of the increase in the maximum base for the credit. The second increase in the maximum base applies to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $101 million in fiscal year 1977, $270 million in fiscal year 1978, and $270 million in fiscal year 1981.

[2] As provided by the committee amendment, the $35 credit is available only through June 30, 1977.

5. Credit for Child Care Expenses (sec. 505 of the bill and secs. 44A, 214 and 3402(m)(2) of the Code)

Present law

Under present law, taxpayers are permitted an itemized deduction for expenses for the care of a dependent child, incapacitated dependent or spouse, or for household services when the taxpayer maintains a household for any of these qualifying individuals. An eligible dependent child must be under age 15 and the taxpayer must be able to claim a personal exemption for him. These expenses must be related to employment; that is, they must be incurred to enable the taxpayer to be gainfully employed.

Eligible expenditures are limited to a maximum of $400 a month. Services provided for children outside the taxpayer's home are further limited to $200 a month for one dependent, $300 for two, and $400 for three or more. (No deduction is allowed for the care of an incapacitated dependent over age 14 or spouse outside the taxpayer's home.) The amount of the eligible expenses which may be deducted is also reduced by one-half of adjusted gross income in excess of $35,000 a year. No deduction is allowed, however, for payments to relatives.

To claim this deduction, a husband and wife must generally file a joint return. Both must be employed substantially full time, that is, three-quarters or more of the normal or customary workweek or the equivalent on the average. However, a spouse who has been deserted for an entire year may be able to file as a single person.

In the case of a disabled dependent, the deductible expenses are reduced by the dependents' adjusted gross income plus disability income in excess of $750.

Reasons for change

The committee believes that the availability of the child and dependent care deduction under present law (sec. 214) is unduly restricted by its classification as an itemized deduction and by its complexity.

Treating child care expenses as itemized deductions denies any beneficial tax recognition of such expenses to taxpayers who elect the standard deduction. The committee believes that such expenses should be viewed as a cost of earning income for which all working taxpayers may make a claim. One method for extending the allowance of child care expenses to all taxpayers, and not just to itemizers, would be to replace the itemized deduction with a credit against income tax liability for a percentage of qualified expenses. While deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides more help for taxpayers in the lower brackets.

Because there is a $400 a month limit on the deduction under present law, a complex child care deduction form is necessary. The child care allowance could be made simpler and the need for a separate form eliminated if it were computed on an annual instead of a monthly basis. The committee also believes that additional, unnecessary complications result from the distinction between expenses for children incurred inside and outside the home and from the requirement that the allowable deduction be reduced by the dependent's disability income.

Allowing the same amount for the expenses of caring for children whether inside or outside the home and replacing the $200, $300 and $400 monthly maximum deductions for such outside expenses for the care of one, two, or three children, with annual ceilings based on one and two or more dependents, would further reduce the complexity of the provision.

The rule allowing the deduction in the case of joint returns only where both spouses work full time seems unduly restrictive. The full-time earnings test was intended to prevent one spouse from working part time, perhaps in a nominal capacity, in order to obtain the benefits of a deduction which could amount to $4,800 a year. The committee believes this type of abuse could be prevented by an alternative rule limiting the allowable expenses to the earnings of the spouse with the smaller earnings. Such a limitation would enable a married or single taxpayer with a qualifying dependent to treat child care expenses as a cost of earning income.

The committee also believes that child care expenses should be allowed when one spouse works and the other is a full-time student. The spouse attending school cannot reasonably be expected to provide child care to enable the other spouse to work. In these circumstances, the expenses incurred to pay for child care are, in fact, necessary for the taxpayer to be gainfully employed.

The committee believes that the one-year waiting period before a deserted spouse may claim child care expenses is too long and has adopted a shorter qualifying period to mitigate hardships.

Limiting the deduction of child care expenses to parents who claim a child as a dependent denies the deduction to a divorced or separated parent with custody of a child, who does not supply more than half of the child's support and cannot claim the child as a dependent, but who may nevertheless incur child care expenses in order to work. The committee believes that the parent who has custody of the child for the greater period of the year should be allowed to treat the child care expenses as a cost of earning income, provided the parent who has custody for the shorter period does not claim such expenses.

The committee also views the bar on deducting payments to relatives for the care of children as overly restrictive. Relatives generally provide superior attention. In order to cover the child care expenses paid to relatives and also to limit the risks of abuse (such as splitting or transferring income by gift to relatives who are in lower brackets or have incomes below taxable levels) the committee has provided the child care allowance only for those payments made to a relative who is not the taxpayer's dependent and whose wages are subject to social security tax.

The committee views qualified child care expenses as a cost of earning income and believes that an income ceiling on those entitled to the allowance has minimal revenue impact, if the allowance is in the form of a credit. Therefore, it considers it appropriate and feasible to eliminate the income phaseout and to allow all taxpayers to claim such expenses regardless of their income level.

Explanation of provision

The committee amendment replaces the itemized deduction for household and dependent care expenses with a nonrefundable income tax credit. Taxpayers with qualified expenses may claim a credit against tax for 20 percent of the expenses incurred (up to certain limits) for the care of a child under age 15 or for an incapacitated dependent or spouse, in order to enable the taxpayer to work. The income limit of $35,000 beyond which the deduction is phased out is to be removed. The House bill provision is almost identical to the committee amendment.

Although the amendment changes the nature of a claim for child care expenses to a credit, it retains the basic rules for determining qualified expenses with some modifications and extensions.

Several changes simplify the tax return by eliminating the need for a separate child care schedule. One such change replaces the present monthly maximum allowance for expenses for children outside the home ($200 for one dependent, $300 for two dependents, and $400 for three dependents) with an annual credit of 20 percent of a maximum of $2,000 for one dependent and $4,000 for two or more dependents, whether the expenses are for services inside or outside the home. (No credit, however, is allowed for the expenses for the care of a dependent over age 14 or a spouse outside the home.) With a 20-percent credit, the maximum credit would be $400 for one dependent and $800 for two or more.

The amendment also extends the credit to married couples, where the husband or wife, or both, work part-time. (Presently, both are required to work full-time.) The eligible expenses are to be limited to the amount of earnings of the spouse earning the smaller amount, or in the case of a single person, to his or her earnings. The deduction also is to be made available to married couples where one is a full-time student and the other spouse works. For purposes of the earnings limitation, the amendment assumes that the student earns $166 a month if there is one dependent and $333 a month if there are two or more dependents.

The credit is available to married couples only if they file a joint return. The credit is extended to a divorced or separated parent who has custody of a child under age 15 even though the parent may not be entitled to a dependency exemption for the child, provided the parent claiming the credit has custody of the child for a longer period during the year than the other parent. A deserted spouse is eligible for the credit when the deserting spouse is absent for the last 6 months of the taxable year intsead of an entire year. Finally, the requirement that the allowable expenses be reduced by disability income received by the dependent is eliminated.

The entire allowance of $2.000 or $4,000 a year is available to a taxpayer who has one or two qualifying dependents, respectively, at any time during the course of the taxable year. However, only those expenses incurred on behalf of a qualifying individual during the period when the individual was a qualifying individual are eligible. For example, a taxpayer whose child reaches age 15 in April would be eligible for the entire $2,000 limit and no prorating would be required. However, only those expenses incurred prior to the child's fifteenth birthday would be eligible.

The amendment repeals the disqualification of any amounts paid to relatives. The amendment allows a credit for child care expenses paid to relatives who are not dependents of the taxpayer even if they are members of the taxpayer's household, provided the relative's earnings are subject to social security tax (that is, the relative's services constitute employment within the meaning of sec. 3121(b)). The committee amendment is the same as the House bill in this respect except that the committee deleted the provision in the House bill which, as one of the conditions, requires the relative not to be a member of the taxpayer's household in order for the credit to be available.

The amendment also makes a conforming change to allow the credit to be considered for purposes of additional withholding allowances. Under present law (sec. 3402(m)(2)) additional withholding allowances are permitted to be claimed for itemized deductions. Changing the child care provision from a deduction to a tax credit makes it impossible for an employee to avoid the overwithholding attributable to the child care expenses. To avoid this overwithholding, the amendment gives the Secretary of the Treasury the authority to provide withholding allowance tables which take into account tax credits to which employees are entitled. It is intended that these tables may take into account the credit for child care expenses, the new tax credit for the elderly, and such other tax credits as the Secretary may find appropriate. Because the credit for child care expenses is 20 percent of the eligible expenses and because of the earned income limit, the tables may be designed to reflect less than the entire amount of such expenses for higher income taxpayers, for example, in order to make the withholding change closely approximate the reduction in tax liability. (Similarly, the full amount of the tax credit for the elderly might not be reflected in such tables, particularly where the income phaseout is operative.)

It is estimated that the number of returns benefiting from the child care provision will approximately double from about 2 million to nearly 4 million. Of the 4 million, approximately 3 million will benefit compared to present law and about 1 million will lose relatively small amounts because of the change from an itemized deduction to a 20-percent credit.

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by $346 million in fiscal year 1977, $363 million in fiscal year 1978, and $483 million in fiscal year 1981.

6. Sick Pay and Certain Military, Etc. Disability Pensions (sec. 506 of the bill and secs. 104 and 105 of the Code)

a. Sick pay

Present law

Under present law, gross income does not include amounts received under wage continuation plans when an employee is "absent from work" on account of personal injuries or sickness. The payments that are received when an employee is absent from work are generally referred to as "sick pay" (under sec. 105(d)).

The proportion of salary covered by the wage continuation payments and any hospitalization of the taxpayer determines whether or not there is a waiting period before the exclusion applies.·If the sick pay is more than 75 percent of the regular weekly rate, the waiting period before the exclusion is available is 30 days whether or not the taxpayer is hospitalized during the period. If the rate of sick pay is 75 percent or less of the regular weekly rate and the taxpayer is not hospitalized during the period, the waiting period is 7 days. If the sick pay is 75 percent or less of the regular weekly rate and the taxpayer was hospitalized for at least 1 day during the period, there is no waiting period and the sick pay exclusion applies immediately. In no case may the amount of "sick pay" exceed $75 a week for the first 30 days and $100 a week after the first 30 days. (These amounts may be doubled on a joint return if each taxpayer is separately eligible for the maximum.)

During the period that a retired employee is entitled to the sick pay exclusion, he may not recover any of his contributions toward any annuity under section 72.[1]

Reasons for change

Section 105(d) which provides the exclusion for "sick pay" is extremely complex. The provision's complexity requires a separate 28-line tax form which is sufficiently difficult that many taxpayers must obtain professional assistance in order to complete it and avail themselves of the exclusion. The committee believes that elimination of the complexity in this area is imperative.

In addition, the present sick pay provision causes some inequities in the tax treatment of sick employees compared to working ones and the treatment of lower-income taxpayers compared to those with higher incomes. Excluding sick pay payments (received in lieu of wages) from income when an employee is absent from work, while taxing the same payments if made as wages while he is at work, is not justified. A working employee generally incurs some costs of earning income not incurred by a sick employee who stays at home. The latter may incur additional medical expenses on account of his sickness; but he may deduct some expenses as medical expenses if they exceed the percentage of income limitations.

Under present law, low- and middle-income taxpayers receive on a percentage basis less benefit from the sick pay exclusion than do taxpayers in higher marginal tax brackets because of the progressivity of tax rates. As a result, more than 60 percent of the benefits from this provision currently goes to taxpayers with adjusted gross incomes (including sick pay) over $20,000. Taxpayers who receive no sick pay, of course, receive no benefit at all. The committee believes that the exclusion allowed under section 105 should not have a regressive effect and that the provision should be amended to direct a fairer share of its tax benefits to low- and middle-income taxpayers.

Explanation of provision

The committee amendment repeals the present sick pay exclusion and substitutes a maximum annual exclusion of $100 a week ($5,200 a

[1] Reg. sec. 1.72–15 (b) and (c) (2).

year per taxpayer or up to $10,400 on a joint return) for taxpayers under age 65 who have retired on disability and are permanently and totally disabled.

For purposes of this provision, the committee does not intend the term "retired" to mean that an employee must have gone through a formal retirement procedure, even if his employer has one, but means that the individual (whether or not an employee) has ceased active employment in all respects because of his disability. The committee understands that there are situations where employers retained employees who have become permanently disabled on their payroll under long-term disability programs which they have either purchased by contract for their employees or which they cover themselves. In these cases, the employer may continue to cover the disabled employee under the company fringe benefit programs, such as life and health insurance coverage. The committee believes that the new provisions should be available in these types of situations as well as when the employee is formally retired.

Under this amendment, permanently and totally disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. The committee has indicated that it expects that proof of disability must be substantiated by the taxpayer's employer (if any) who is to certify this status under general procedures approved in advance by the Internal Revenue Service. (This is to be a general set of procedural rules set up by the Service, not advance approval for each employer.) The Service may also issue regulations requiring the taxpayer to provide proof from time to time that he is still disabled. (After age 65, taxpayers will be eligible for the revised elderly credit.)

The maximum amount excludable is to be reduced on a dollar-for-dollar basis by the taxpayer's adjusted gross income (including disability income) in excess of $15,000 (this amount applies to both joint and single returns). Thus, if a taxpayer receives $5,200 in disability income and $15,000 (or more) in other income which together equal $20,200 (or more), he would not be entitled to any exclusion of his disability payments.

In order to claim this exclusion, a taxpayer who is married at the close of a taxable year must file a joint return with his or her spouse, unless they have lived apart at all times during that year.

The committee amendment provides that after a taxpayer has reached age 65, he can begin to recover his investment in an annuity contract (if any) by deeming the employee's investment in the contract for the purpose of section 72 to be zero until the beginning of the taxable year in which he attains age 65 or until the beginning of an earlier taxable year for which the taxpayer makes an irrevocable election not to seek the benefits of the disability income exclusion for that year or subsequent years. This provision enables taxpayers who decide they will not be able to claim any disability income exclusion to benefit from the section 72 exclusion before age 65.

The committee amendment also provides a transitional rule allowing persons who, before January 1, 1976, retire on disability or who were entitled to retire on disability, and on January 1, 1976, were permanently and totally disabled (though they may not have been permanently and totally disabled on their retirement date) to claim a disability income exclusion if they otherwise qualify.

The new rules will apply both to civilians and to military personnel. However, Veterans' Administration payments remain completely exempt from tax.

The House bill provision is almost identical to the committee amendment.

Effective date

This provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $347 million in fiscal year 1977, $357 million in fiscal year 1978, and $450 million in fiscal year 1981.

b. Disability Pensions of the Military, etc.

Present law

Present law excludes from gross income amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, as well as similar amounts received by disabled members of the National Oceanic and Atmospheric Administration (NOAA, formerly called the Coast and Geodetic Survey), the Public Health Service, or the Foreign Service (sec. 104(a)(4)).[2] In addition, payments of benefits under any law administered by the Veterans' Administration are excludable from gross income (section 3101(a) of Title 38 of the United States Code). Thus, disability benefits administered by the Veterans' Administration are exempt from tax under present law.

Reasons for change

The committee is concerned with two somewhat conflicting aspects of the exclusion of disability payments from gross income: on the one hand, the abuse of the exclusion in certain instances, particularly by retiring members of the armed forces, and on the other hand, the expectation and reliance of present members of the affected government services, especially the armed forces, on the government benefits available to them when they entered government employment or enlisted in or were drafted into the military.

Criticism of the exclusion of armed forces disability pensions from income focuses on a number of cases involving the disability retirement of military personnel. In many cases, armed forces personnel have been classified as disabled for military service shortly before they would have become eligible for retirement principally to obtain the benefits of the special tax exclusion on the disability portion of their retirement pay. In most of these cases the individuals, having retired from the military, earn income from other employment while receiving tax-free "disability" payments from the military. The committee

[2] Under present regulations (Reg. sec. 1.105—4(a)(3)(i)(a)), the portion of a disability pension received by a retired member of the armed forces which is in excess of the amount excludable under section 104(a)(4) is excluded as sick pay under a wage continuation plan subject to the limits of section 105(d) if such pay is received before the member reaches retirement age.

questions the equity of allowing retired military personnel to exclude the payments which they receive as tax-exempt disability income when they are able to earn substantial amounts of income from civilian work, despite disabilities such as high blood pressure, arthritis, etc.

However, in order to provide benefits to present personnel who may have joined or continued in the government or armed services in reliance on possible tax benefits from this provision, the committee believes any changes in the tax treatment of military disability payments should affect only future members of the armed forces, NOAA, Public Health Service and Foreign Service.

Explanation of provision

The committee amendment eliminates the exclusion of disability payments from income for those covered under section 104(a)(4), that is, members of the armed forces of any country, NOAA, the Public Health Service and the Foreign Service. This change applies only prospectively to persons who join these government services after September 24, 1975. Specific exceptions continue the exclusion in certain cases for future disability payments for injuries and sickness resulting from active service in the armed forces of the United States.

At all times, Veterans' Administration disability payments will continue to be excluded from gross income. In addition, even if a future serviceman who retires does not receive his disability benefits from the Veterans' Administration, he will still be allowed to exclude from his gross income an amount equal to the benefits he could receive from the Veterans' Administration. Otherwise, future members of the armed forces will be allowed to exclude military disability retirement payments from their gross income only if the payments are directly related to "combat injuries." A combat-related injury is defined as an injury or sickness which is incurred as a result of any one of the following activities: (1) as a direct result of armed conflict; (2) while engaged in extra-hazardous service, even if not directly engaged in combat; (3) under conditions simulating war including maneuvers or training; or which is (4) caused by an instrumentality of war, such as weapons. This definition of combat-related injuries is meant to cover an injury or sickness attributable to the special dangers associated with armed conflict or preparation or training for armed conflict.

All persons who were members of the armed forces of any country (or a military reserve unit), the National Oceanic and Atmospheric Administration, the Public Health Service and the Foreign Service as of September 24, 1975, or who as of that date were subject to a written binding commitment to enter these Government services or were retirees from these services receiving disability retirement payments which are excluded from their gross income under present law, will continue to exclude such payments from gross income under the committee's decision. In addition, disability benefits administered by the Veterans' Administration will continue to be exempt from tax, as under present law.

The House bill provision is the same as the committee amendment.

Effective date

This provision is to apply to members of the armed forces of any country, the National Oceanic and Atmospheric Administration, the

Public Health Service and the Foreign Service who joined these services after September 24, 1975. Otherwise, the provision applies to taxable years beginning after December 31, 1975.

Revenue effect

The changes in the disability exclusion for military, etc. pensions will have no revenue impact until substantial numbers of persons entering government service after September 24, 1975, retire.

7. Moving Expenses (sec. 507 of the bill and secs. 217 and 82 of the Code)

Present law

An employee or self-employed individual may claim a deduction from gross income for the expenses of moving to a new residence in connection with beginning work at a new location (sec. 217). Any amount received directly or indirectly as a reimbursement of moving expenses must be included in a taxpayer's gross income as compensation for services (sec. 82), but he may offset this income by deducting expenses which would otherwise qualify as deductible items.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old to the new residence; the cost of meals and lodging enroute; the expenses for premove househunting trips; temporary living expenses for up to 30 days at the new job location; and certain expenses related to the sale or settlement of a lease on the old residence and the purchase of a new one at the new job location.

The moving expense deduction is subject to a number of limitations. A maximum of $1,000 may be deducted for premove househunting and temporary living expenses at the new job location. A maximum of $2,500 (reduced by any deduction claimed for househunting or temporary living expenses) may be deducted for certain qualified expenses for the sale and purchase of a residence or settlement of a lease. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts are halved.

In order for a taxpayer to claim a moving expense deduction, his new principal place of work must be at least 50 miles farther from his former residence than was his former principal place of work (or his former residence, if he had no former place of work).

During the 12-month period following his move, the taxpayer must be a full-time employee in the new general location for at least three-fourths of the following year, that is, 39 weeks during the next 12-month period. A self-employed person must, during the 24-month period following his arrival at his new work location, perform services on a full-time basis for at least 78 weeks, with at least 39 weeks of full-time work falling within the first 12 months. Even if the 39- or 78-week requirement has not been fulfilled at the end of a taxable year (but may still be fulfilled), the taxpayer may elect to deduct any qualified moving expenses which he has paid or incurred provided he has met all the other requirements. If he fails to meet the full-time employment period requirements in a subsequent taxable year, he must, include the amounts previously deducted in his gross income for the subsequent year.[1]

Pursuant to statutory authorization,[2] the Secretary of the Treasury has entered into agreements with the Secretary of Defense for members of the Army, Navy, and Air Force, and with the Secretary of Transportation for members of the Coast Guard to allow special treatment for servicemen's moving expenses for taxable years ending before January 1, 1976.

As a result, the Secretaries of Defense and of Transportation are not required to report or withhold tax on moving expense reimbursements made to members of the armed forces, nor are members of the armed forces required to include in income the value of in-kind moving services provided by the military. However, members of the armed forces may deduct moving expenses to the extent they exceed military reimbursements, and would otherwise qualify as deductible expenditures under section 217, without counting any military in-kind reimbursements against the dollar limitation.

Reasons for change

The present provisions for moving expenses reflect significant revisions made by the Tax Reform Act of 1969. Generally, the committee believes that the basic rationale and requirements of this provision remain sound.

The mobility of labor continues to be important in the economy of the United States. Frequently, employers must transfer employees from one location to another and workers must change their residence in order to obtain better employment opportunities. The substantial moving expenses incurred by many taxpayers in connection with employment-related moves may be viewed as a cost of earning income. Allowing a tax deduction for certain moving expenses helps achieve a more accurate account of a taxpayer's net income.

Despite inflation between 1969 and 1975, there has been no adjustment of the $1,000 and $2,500 ceilings on moving expense deductions. The committee believes that these ceilings should be set at higher dollar levels. However, the committee does not believe that the two ceilings have to be increased proportionately.

The 50-mile test restricts the deduction of expenses to a move to a new job location which is 50 miles farther from the taxpayer's former residence than has his former principal place of work (or his former residence if he had no former place of work). For example, if a taxpayer's former residence was 30 miles from his former job, his new job location must be at least 50 miles farther from his former residence; that is, it must be a total of at least 80 miles, if his moving expenses are to be deductible. Recognizing the increasing cost of commuting, the growing concern for gasoline conservation, and the continuing inadequacy of mass transportation in most areas of the country, the committee believes some reduction of the 50-mile test is appropriate.

Certain changes made in the 1969 Act created unforeseen administrative difficulties for the military. The Department of Defense and the Department of Transportation (with respect to the peacetime Coast Guard) apparently have no economically feasible procedure

[1] The 39- and 78-week tests are waived if the employee is unable to satisfy them as a result of death, disability, or involuntary separation (other than for willful misconduct).

[2] P.L. 93–490, sec. 2, 88 Stat. 1466, 93rd Cong., 2d Sess., October 26, 1974.

for identifying or valuing the in-kind reimbursements provided for each serviceman where the military pays a mover for the moving expenses, or does the moving itself. The Department of Defense, acting on behalf of all the military services, indicated in discussions with the Internal Revenue Service that establishing such a system for identifying reimbursed moving expenses would involve substantial administrative burdens for the Department, as well as increasing its expenses, at no revenue gain to the Treasury. As a result of these administrative problems, the Internal Revenue Service in 1971 agreed to a moratorium for the reporting and reimbursement rules (except for cash reimbursements) in the case of the military. The Service extended this administrative moratorium through 1972 and 1973. As indicated above, in 1974 the armed forces were exempted from these requirements by legislation effective through December 31, 1975.

The committee agrees that requiring the military to report and withhold tax on reimbursed in-kind moving expenses and requiring servicemen to include such reimbursements in income would entail needless, costly administration by the military services.

In addition, the military has found the mileage limitation (the 50-mile limit) and the 39-week rule a hardship for military personnel because many mandatory personnel moves are for less than 30 weeks and for less than 50 miles. The committee believes that servicemen who are required to change their residence incident to a permanent change of station should not be required to include in income the in-kind moving assistance provided by the military and should not be denied a deduction for otherwise deductible expenses involved in a mandatory move only because they fail the time and mileage tests. Therefore, the committee exempts members of the armed forces from the time and mileage limitations for moves incident to a permanent change of station when the military authorizes in-kind moving assistance. The committee also believes it appropriate to exclude from income the in-kind moving services and assistance provided to move servicemen's dependents to a home location within the United States when military requirements prevent the dependents from accompanying the servicemen.

Explanation of provision

The committee amendment modifies the present treatment of job-related moving expenses in a number of respects. The amendment increases the maximum deduction for premove househunting and temporary living expenses at the new job location from $1000 to $1500 and increases from $2500 to $3500 the maximum deduction for qualified expenses for the sale, purchase or lease of a residence (reduced by any deduction claimed for premove househunting or temporary living expenses). As with the existing limitations, the new amounts are halved if a husband and wife file separate returns. The committee amendment also reduces the 50-mile rule to 35 miles. The House bill is the same with respect to these two provisions, except that the overall maximum deduction under the House bill is $3000.

Several exemptions are provided for the Department of Defense, the Department of Transportation and members of the armed forces of the United States on active duty. The departments and servicemen are not required to report as income to the servicemen, nor to withhold tax on, any in-kind moving assistance provided by the military for moves pursuant to a military order and incident to a permanent change of station for which a change of residence is required. Members of the armed forces may, however, deduct any qualified moving expenses subject to the generally applicable dollar limitations to the extent such expenses exceed authorized in-kind military assistance without reducing the dollar limitations by the amount of any in-kind assistance provided by the military.

The committee amendment also exempts members of the armed forces from the 35-mile limitation and from the 39-week rule in the case of required moves incident to a permanent change of station. In addition a member would be permitted to exclude in-kind services provided by the military for moving the family to a point within the U.S. when the member is assigned overseas or to Alaska, where the spouse cannot accompany the member. The military would not be required to report such assistance for dependents.

The House bill contains the same provisions for the military except for the allowance of the cost of moving a spouse to a place in the U.S. while the member is stationed overseas or in Alaska pursuant to a military order.

Effective date

This provision is to apply generally to taxable years beginning after December 31, 1976, except that the military provisions are to apply for years after 1975.

Revenue effect

This provision will reduce budget receipts by $10 million in fiscal year 1977, $67 million in fiscal year 1978, and $90 million in fiscal year 1981.

F. BUSINESS-RELATED INDIVIDUAL INCOME TAX REVISIONS

1. Deductions for Expenses Attributable to Business Use of Homes (sec. 601 of the bill and new sec. 280 of the Code)

Present law

Under present law, no deductions are allowed for personal, living, and family expenses except as expressly allowed under the code (sec. 262). Generally, under this provision, expenses and losses attributable to a dwelling which is occupied by a taxpayer as his personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions of the tax laws (secs. 163, 164 and 165). Moreover, if a portion of the residence is used in the taxpayer's trade or business or is used in the production of income, a deduction may be allowed for an allocable portion of the expenses incurred in maintaining such personal residence.

In any case involving the business use of a personal residence, it must be established that the expenses were incurred in carrying on a trade or business (sec. 162) or for the production of income (sec. 212). Thus, there must be some relatively clear connection between the activities conducted in the home and a trade or business or the production of income. Under the regulations (Reg. § 1.262–1(b)(3)), the expenses of maintaining a household are treated as nondeductible personal expenses if the taxpayer only incidentally conducts business in his home. However, if a part of the house is used as the taxpayer's place of business, the allocable portion of the expenses attributable to the use of the home as a place of business is allowed as a deduction.

For this purpose the expenses attributable to the office or business use of the home are deductible if they are "ordinary and necessary" expenses paid or incurred in carrying on a trade or business or for the production of income. These expenses are claimed as deductions by self-employed individuals who use portions of their residences for trade or business purposes, employees who maintain offices in connection with the performance of their duties as employees, or investors who maintain offices in connection with investment activities. Typically, the expenses for which a deduction is claimed include an allocable portion of the depreciation or rent, maintenance, utility, and insurance expenses incurred in connection with the residence.

With respect to the maintenance of an office in an employee's home, the position of the Internal Revenue Service is that the office must be required by the employer as a condition of employment and regularly used for the performance of the employee's duties. (Revenue Ruling 62–180, 1962–2 C.B. 52, sets forth these standards as they apply to the deductibility of expenses attributable to an office maintained in an employee's home.)

Certain courts have held that a more liberal standard than that applied by the Internal Revenue Service is appropriate. Under these decisions, the expenses attributable to an office maintained in an employee's residence are deductible if the maintenance of the office is "appropriate and helpful" to the employee's business: *George H. Newi*, T.C. Memo. 1969–131, aff'd 432 F. 2d 998 (2d Cir. 1970); *Jay R. Gill*, T.C. Memo. 1975–3; *Hall* v. *United States*, 387 F. Supp. 612 (D.C. N.H., 1975).

In *Stephen A. Bodzin*, 60 T.C. 820 (1973), the Tax Court, in a decision allowing a deduction for an office in an employee's residence, held that "the applicable test for judging the deductibility of home office expenses is whether, like any other business expense, the maintenance of an office in the home is appropriate and helpful under all the circumstances." However, the court cautioned that no deduction would be allowable if personal convenience were the primary reason for maintaining the office notwithstanding any conclusion as to the "appropriateness" and "helpfulness" of the office. On appeal, the Fourth Circuit reversed the decision of the Tax Court (509 F. 2d 679). The Court of Appeals held that, as a factual matter, the expenses attributable to the taxpayer's residence were nondeductible personal expenses and that it was therefore unnecessary to decide if the maintenance of the office was appropriate and helpful in carrying on his business. Thus, it is not clear which standard would be applied in the Fourth Circuit in a case in which the court found both personal and business use of a residence. However, the court suggested that to obtain a deduction, an employee would have to show that the office provided by the employer is not available at the times the employee uses the office in his residence or that the employer's office is not suitable for the purposes for which the taxpayer is using the office in his residence.[1]

The Tax Court has also applied the "appropriate and helpful" standard to determine the deductibility of expenses attributable to the maintenance of an office in the home of an investor. (*Lena M. Anderson*, TC Memo 1974–49.) In that case, the taxpayer was allowed a portion of the expenses attributable to a family room which was partially used to conduct investment activities which consisted of keeping records with respect to rental properties, preparing the taxpayer's income tax returns, and writing letters to brokers and taxing authorities.

With respect to an apartment or residence used by a taxpayer while in a travel status, the expenses attributable to the maintenance of the apartment or residence are treated as lodging expenses subject to certain other rules relating to deductibility (sec. 162). As such, the expenses are deductible only if they are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable deductions. The expenses attributable to the apartment or house are deductible as lodging expenses if properly allocable to the taxpayer's trade or business even though the transportation expenses are not deductible because the trip was undertaken primarily for personal purposes.

[1] The Supreme Court denied certiorari in the *Bodzin* case on October 6, 1975 (44 U.S.L.W. 3201).

Additional requirements also apply with respect to a residence where the business use consists of entertainment of clients, customers, or business associates. In such cases, the residence is treated as an entertainment facility, and no deduction is allowed for any expenditure unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item of expense was directly related to the active conduct of such trade or business (sec. 274).

In determining whether or not an entertainment facility was used primarily for the furtherance of the taxpayer's trade or business, the taxpayer must establish that the primary use of the facility was ordinary and necessary based upon the facts and circumstances considered on a case-by-case basis. Generally, the actual use of the facility is controlling, and not its availability for use. The factors to be considered include the nature of each use, the frequency and duration of business use and the amount of expenditures incurred for business purposes.

The regulations provide that with respect to an entertainment facility, a taxpayer is deemed to have established that an entertainment facility was used primarily for the furtherance of his trade or business if more than 50 percent of the total calendar days of use of the facility during any taxable year were business use days.

An expenditure shall be considered directly related to the active conduct of the taxpayer's trade or business if four requirements are met: (1) the taxpayer had more than a general expectation of deriving income or benefit (other than goodwill) at some indefinite future time; (2) the taxpayer actually engaged in, or reasonably expected to engage in, business meetings, negotiations, etc., for the purpose of obtaining income or other benefits; (3) in light of all the facts and circumstances, the principal function of the combined business meeting, etc., and entertainment was the active conduct of the taxpayer's trade or business, and (4) the expenditure was allocable to the taxpayer and person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment.

In determining the deductible amount attributable to the business use of the home, the general rule is that any reasonable method of allocation may be used. In all cases involving the dual use of a home, the allocation of expenses attributable to the portion of the residence used for business purposes will take into account the space used for those purposes, e.g., a percentage of the expenses based on the square feet of that portion compared to the total square feet of the residence. In addition, a further allocation based on time of use is required when the portion of the residence is not exclusively used for business purposes. In Rev. Rul. 62–180, 1962–2 C.B. 52, 54, the Internal Revenue Service held that, after allocating expenses attributable to a den used for business and personal purposes on the basis of space, a further allocation must be made on the basis of time of use to reflect the dual use. For purposes of the latter allocation, the Service ruled that the allocation should be made on the basis of availability for use rather than actual use, i.e., the ratio of time actually used for business purposes to the total time it is available for all uses. However, in *George W. Gino*, 60 T.C. 304, 314 (1973) (followed in *Lena M. Anderson*, T.C. Memo.

1974–49), the Tax Court held that such expenses should be allocated on the basis of actual business use as compared with actual total use.

In another case where the allocation could not clearly be determined, the *Cohan* rule was applied to estimate the approximate space of an apartment which was used for business purposes. *George H. Newi*, T.C. Memo. 1969–131, aff'd., 432 F. 2d 998 (2d Cir. 1970). The *Cohan* rule provides, generally, that where there is evidence that the taxpayer incurred certain deductible expenses but the exact amount cannot be determined, a close approximation would be acceptable and, therefore, the deduction would not be entirely disallowed. Under present law, however, because of certain substantiation requirements, no deduction is allowed for certain expenditures relating generally to travel or entertainment on the basis of a *Cohan* approximation or on the basis of unsupported testimony of the taxpayer.

Reasons for change

The committee believes that there is a great need for definitive rules tto resolve the conflict that exists between several recent court decisions and the position of the Internal Revenue Service as to the correct standard governing the deductibility of expenses attributable to the maintenance of an office in the taxpayer's personal residence.

With respect to the "appropriate and helpful" standard employed in the court decisions, the determination of the allowance of a deduction for these expenses is necessarily a subjective determination. In the absence of definitive controlling standards, the "appropriate and helpful" test increases the inherent administrative problems because both business and personal uses of the residence are involved and substantiation of the time used for each of these activities is clearly a subjective determination. In many cases the application of the appropriate and helpful test would appear to result in treating personal living, and family expenses which are directly attributable to the home (and therefore not deductible) as ordinary and necessary business expenses, even though those expenses did not result in additional or incremental costs incurred as a result of the business use of the home. Thus, expenses otherwise considered nondeductible personal, living, and family expenses might be converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence. For example, if a university professor, who is provided an office by his employer, uses a den or some other room in his residence for the purpose of grading papers, preparing examinations or preparing classroom notes, an allocable portion of certain expenses might be claimed as a deduction even though only minor incremental expenses were incurred in order to perform these activities.

Explanation of provision

The committee amendment adds a new provision (sec. 280) which provides, in part, that no deductions shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer as a residence, unless specifically excepted from this new section and otherwise allowable. The provisions of this section apply to individuals, trusts, estates, partnerships, and electing small business corporations. This section does not apply to a corporation (other than an electing small business corporation).

The general disallowance provision of this section, however, does not apply with respect to certain expenses which are otherwise allowable as deductions: for example, the deductions allowable for interest (sec. 163), certain taxes (sec. 164) and casualty losses (sec. 165) may still be claimed as deductions without regard to their connection with the taxpayer's trade or business or income producing activities.

Under the committee amendment, a deduction will not be disallowed in the case of a taxpayer who uses a portion of a dwelling unit exclusively and on a regular basis either: (1) as his principal place of business, (2) as the sole fixed location of the taxpayer's trade or business of selling goods or services at retail or wholesale (but only if such portion is used in connection with such sale of such goods or services), (3) as a place of business which is used for patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or (4) in connection with the trade or business of an employer where the employer provides no office or fixed location for the use of the employee. Also, the committee amendment provides that a deduction will not be disallowed in the case of a taxpayer who, in connection with his trade or business, use a separate structure which is not attached to his dwelling unit (e.g., an artist's studio in a structure adjacent to but unattached to his residence). In the case of an employee, a deduction for the portion of the ordinary and necessary business expenses attributable to the use of a residence which are paid or incurred in connection with the performance of services as an employee will be allowable under the situations described above only if, in addition to satisfying the exclusive use and regular basis tests, the use is for the convenience of his employer.

The committee amendment provides an exception to the exclusive-use test in the case of a taxpayer whose trade or business is selling products at retail or wholesale and whose dwelling unit is the sole fixed location of such trade or business. Under this exception, the ordinary and necessary expenses allocable to space (within a dwelling unit) which is used as a storage unit for inventory will not be disallowed. However, the space must be used on a regular basis and must be a separately identifiable space suitable for storage.

Exclusive use of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The use of a portion of a dwelling unit for both personal purposes and for the carrying on of a trade or business does not meet the exclusive use test. Thus, for example, a taxpayer who uses a den in his dwelling unit to write legal briefs, prepare tax returns, or engage in similar activities as well for personal purposes, will be denied a deduction for the expenses paid or incurred in connection with the use of the residence which are allocable to these activities. Also, with respect to a separate structure not attached to the dwelling unit, if the taxpayer uses such structure (e.g., a detached garage) for both trade or business and personal purposes, the exclusive use test is not met.

In addition to the exclusive use test, the committee's amendment requires that the portion of the residence used for trade or business purposes must be used by the taxpayer on a regular basis in order for the allocable portion of the expenses to be deductible. Expenses attributable to incidental or occasional trade or business use of an exclusive portion of a dwelling unit would not be deductible even if that portion of the dwelling unit is used for no other purpose.

An allocable portion of expenses paid or incurred with respect to the use of a dwelling unit which is used by the taxpayer both as a residence and in connection with income producing activities (sec. 212) will not be allowable as deductions under the provisions of this section unless the income producing activity constitutes a trade or business. For example, no deduction will be allowed if a taxpayer who is not in the trade or business of making investments, uses a portion of his residence (exclusively and on a regular basis) to read financial periodicals and reports, clip bond coupons and performs similar activities because the activity is not a trade or business.

The committee amendment also provides an overall limitation on the amount of deductions that a taxpayer may take for the business use of the home or separate unattached structure. The allowable deductions attributable to the use of a residence or separate unattached stucture for trade or business purposes may not exceed the amount of the gross income derived from the use of the residence or separate unattached structure for that trade or business reduced by the deductions which are allowed without regard to their connection with the taxpayer's trade or business (e.g., interest and taxes). In the case where gross income is derived both from the business use of the residence or separate unattached structure and from the business use of facilities other than the residence or separate unattached structure a reasonable allocation (based on the facts and circumstances of each case) is to be made to determine that portion of the gross income derived from the business use of the residence or separate unattached structure. With respect to the deductions which are allocable to the trade or business use of the residence or separate unattached structure, deductions allowable without regard to whether the activity is a trade or business are to be deducted first. Any remaining gross income may then be reduced (but not below zero) by the remaining allowable deductions which are allocable to such use.

The committee amendment is substantially the same provision as adopted in the House bill except that the general disallowance rule is not applicable to the extent that the exclusively used on a regular basis test is met: (1) where the dwelling unit or portion thereof is the sole fixed location of the taxpayer's trade or business of selling goods or services at retail or wholesale (but only if such portion is used in connection with such sale of such goods or services), (2) where the business use of the residence by the taxpayer is in connection with the trade or business of his employer and no office or fixed location is provided by the employer for use by the employee, and (3) in the case of a separate structure which is not attached to the dwelling unit and where such structure is used in connection with the taxpayer's trade of business. Also, the committee amendment provides an exception to the exclusive use test in the case of a taxpayer whose trade or business is selling products at retail or wholesale and whose dwelling unit is the sole fixed location of such trade or business. Under this exception, the ordinary and necessary expenses allocable to space (within a dwelling unit) which is used as a storage unit for inventory will not be disallowed.

Effective date

This provision shall apply to taxable years beginning after December 31, 1975.

Revenue effect

The revenue effect of this provision is combined with that of the following vacation home provisions.

2. Deduction for Expenses Attributable to Rental of Vacation Homes (sec. 601 of the bill and new sec. 280 of the Code)

Present law

A taxpayer is allowed a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business (sec. 162), or for the management, conservation, or maintenance of property held for the production of income (sec. 212). In order to be entitled to a deduction under these provisions, it is necessary that the activity be engaged in by the taxpayer for profit (i.e., for the purpose of or with the intention of making a profit).[1] The determination of whether an activity is engaged in for profit is to be made on the basis of objective standards, taking into account all facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances (without regard to the taxpayer's subjective intent) must indicate that the taxpayer entered or continued the activity with the objective of making a profit. No deduction is allowed under sections 162 or 212 if the activity is carried on primarily as a sport, hobby, or for recreation.

Even though an activity is not engaged in for profit (and therefore no deduction is allowed under sections 162 or 212), certain deductions are allowed under other provisions of the tax law. Subject to specific limitations discussed below, a deduction is allowed under section 183 for expenditures which are of the type that may be deducted without regard to whether they are incurred in connection with a trade or business or for the production of income. These items include the deductions which are allowed for interest (sec. 163), certain State and local property taxes (sec. 164), and casualty losses (sec. 165).

Section 183 further provides that, in the case of an activity not engaged in for profit, a deduction is allowed for expenses which could be deducted if the activity were engaged in for profit, but only to the extent these expenses do not exceed the amount of gross income derived from the activity reduced by the deductions which are allowed in any event (e.g., interest and certain State and local taxes). In other words, as to expenses such as depreciation, insurance, and maintenance, a taxpayer is allowed a deduction but only to the extent of income derived from the activity. The taxpayer is not allowed to use these deductions to create losses which can be used to offset other income.

A taxpayer is presumed to be engaged in an activity for profit for a taxable year if, in two or more years of the period of five consecutive taxable years (seven consecutive taxable years in the case

[1] See *Morton* v. *Commissioner*, 174 F. 2d 302, 304 (2d Cir.), cert. denied, 338 U.S. 828 (1949); *Schley* v. *Commissioner*, 375 F. 2d 747 (2d Cir. 1967); and *George W. Mitchell*, 47 T.C. 120 (1966).

of an activity which consists in major part of the breeding, training, showing, or raising of horses) ending with such taxable year, the activity was in fact carried on at a profit. For purposes of this presumption, the activity is treated as being carried on for a profit in a given taxable year if the gross income from the activity exceeds the deductions attributable to the activity which would be allowable if it were engaged in for profit.

The rules for determining whether an activity is a trade or business or engaged in for the production of income are the same as those used for determining whether an activity is engaged in for profit. As a result, except for the presumption discussed above, if deductions with respect to the activity are not allowable as a trade or business expense (sec. 162) or as expenses incurred for the production of income, etc. (sec. 212), then the activity will be treated as an activity not engaged in for profit under section 183.

The Regulations provide a list of relevant factors which should normally be taken into account in determining whether the activity is engaged in for profit. Among other factors, the presence of personal motives must be considered, especially where there are recreational or personal elements involved.[2] By way of illustration, the regulations provide that a taxpayer will be treated as holding a beach house primarily for personal purposes if, during a three-month season, the beach house is personally used by the taxpayer for one month and used for the production of rents for the remaining two months (Regs. §1.183–1(d)(3)). However, except for this example, there are no definitive rules relating to how much personal use of vacation property will result in a finding that the rental activities of vacation homes are not engaged in for profit.

Under present law, no deduction is allowed for personal, living, and family expenses except as otherwise expressly provided under the tax laws (sec. 262). Deductions that are expressly allowable, even though they are attributable to personal use, include items of interest, certain taxes, and casualty losses. However, no deduction is allowed for such items as depreciation, maintenance, insurance, and utilities to the extent these items are attributable to personal use. As a result, where property is used for both personal and business use, the total amount of maintenance, insurance, and utilities expenses and depreciation incurred during a taxable year must be allocated on a reasonable and consistently applied basis.

Reasons for change

Where expenses attributable to a residence are treated as deductible business expenses, an opportunity exists to convert nondeductible personal, living and family expenses into deductible expenses. In the case of so-called "vacation homes" that are used both for personal purposes and for rental purposes, the committee believes that frequently per-

[2] Treas. Reg. § 1.183–2(b). These factors include: (1) The manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisers, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that assets used in the activity may appreciate in value, (5) the success of the taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer's history of income or losses with respect to the activity, (7) the amount of occasional profits, if any, which are earned, (8) the financial status of the taxpayer, and (9) the elements of personal pleasure or recreation.

sonal motives predominate and the rental activities are undertaken to minimize the expenses of ownership of the property rather than t^ make an economic profit.

In marketing vacation homes, it has become common practice to emphasize that certain tax benefits can be obtained by renting the property during part of the year, while reserving the remaining portion for personal use. In addition, certain arrangements have been devised whereby an individual owner of a condominium unit is entitled to exchange the time set aside for the personal use of his own unit (typically three to six weeks) for the use of a different unit under the same general management at another location.

Under many of these arrangements, it is extremely difficult under existing law to determine when an activity is engaged in for profit. The present regulations provide that in making this determination, a number of factors shall be taken into account. These factors include the presence of "personal motives", especially where there are recreational or personal elements involved. However, except for the example mentioned above, no objective standards are set forth in the regulations. The committee believes that definitive rules should be provided to specify the extent to which personal use would result in the disallowance of certain deductions in excess of gross income. In a case where personal use is the controlling factor to be considered, this approach would obviate the need to require subjective determinations to be made concerning the taxpayer's motive and the primary purpose for which the vacation home is held.

In addition, if there is any personal use of a vacation home, the portion of expenses allocable to rental activities should be limited to an amount determined on the basis of the ratio of time that the home is actually rented, to the total time for vacation home is used during he taxable year for all purposes (i.e., rental, business, and personal activities).

Explanation of provision

The committee amendment adds a new provision (sec. 280) which, in general, provides a limitation on the amount allowable to a taxpayer for the deductions attributable to the rental of a vacation home if the taxpayer personally uses the home in excess of specified periods of time during a taxable year. This new limitation only applies if the taxpayer's use of the vacation home for personal purposes during his taxable year exceeds the greater of fourteen days or ten percent of the number of the days during the year for which the vacation home is rented. (Rules for determining personal use and rental days are discussed below.) The committee amendment also provides that in the case where the taxpayer rents vacation property for less than one month, neither operating gain nor loss would be recognized for tax purposes. For this purpose, one month means a period aggregating less than 32 days, whether or not consecutive.

The provisions of this section apply to an individual, a trust, estate, partnership, and an electing small business corporation. The provisions do not apply to corporate taxpayers (other than shareholders of subchapter S corporations). However, no inference should be drawn from this section in the case of a corporation, as to whether or not expenses incurred for the maintenance of a residence are connected with its trade or business for purposes of the tax laws.

If a taxpayer exceeds the personal use limitations for the vacation home for a taxable year, the deductions attributable to the rental activity are limited to the amount by which the gross income derived from the rental activity exceeds the deductions otherwise allowable with respect to such rental activities (e.g., interest and certain taxes). For this purpose, deductions attributable to the rental activities are those items which are of a type allowable only as expenses incurred in connection with a trade or business or the production of income (e.g., sec. 162 or 212).

If the personal use limitation applies, the allowable deductions would be determined after first determining the expenses of the vacation home which are allocable to the rental activities (in accordance with the new allocation rules). The amounts allowable as deductions would be determined in the same manner as provided in the regulations prescribed under section 183 of the Code.

The applicability of this new limitation on allowable deductions would be determined solely by reference to the taxpayer's personal use of the vacation home during his taxable year rather than, as under section 183, by reference to the profits or losses during any consecutive period of taxable years or on the basis of a facts and circumstances determination of the taxpayer's objectives. Generally, application of section 183 of the code would not be affected by these new provisions. Thus, if the rental of a vacation home is treated as an activity not engaged in for profit after consideration of the relevant objective standards prescribed by the regulations under section 183, deductions attributable to the rental activity would be limited under that provision (sec. 183) even though the new provisions did not apply because there was little or no personal use of the vacation home.

As indicated above, in the case where the vacation property is rented for less than one month during the taxable year, neither operating gain nor operating loss would be recognized for Federal income tax purposes. Thus, where a vacation home is rented for less than one month, neither the new limitation under this new section nor the provisions of section 183 (pertaining to activities not engaged in for profit) are applicable. In this case, expenses which would be allowable if the taxpayer were in a trade or business or subject to the provisions of section 183 (e.g., maintenance, utilities, insurance and depreciation) will not be allowed as a deduction and any revenue received from the rental of a vacation home for less than one month will not be includible for tax purposes. However, a deduction for expenses otherwise allowable (e.g., interest, certain taxes and casualty losses) will be allowed as a deduction.

This new limitation, as indicated above, will not apply unless the taxpayer uses the vacation home for personal purposes during his taxable year for more than fourteen days or ten percent of the number of the days during such year for which the vacation home is rented, whichever is greater. For this purpose, a vacation home would not be treated as rented (at a fair rental) for any day for which it is treated as used for personal purposes. In the case of a vacation home owned by a partnership, trust, estate, or subchapter S corporation, the number of days of personal use of the vacation home by a taxpayer shall be determined by reference to the total number of days of personal use by the partners, beneficiaries, or stockholders, as the case may be. However, if two or more partners, beneficiaries, or stockholders personally use the vacation home during the same day, that day would constitute only one day of personal use. If a taxpayer owns a vacation home during only a portion of the taxable year, no reduction of the personal use specified under the provision would be required by reason that the vacation home was owned for less than a full year.

The taxpayer generally would be deemed to have used a vacation home for personal purposes for a day if, for any part of the day, the home is used for personal purposes by (1) the taxpayer or any other person who owns an interest in the home; (2) their brothers and sisters, spouses, ancestors, lineal descendants, or spouses of lineal descendants; (3) any individual who uses the home under a reciprocal arrangement (whether or not a fair rental is charged); or (4) any other individual who uses the vacation home during a day unless for that day the home is rented for a fair rental. With respect to use by a person other than the taxpayer who also owns an interest in the vacation home, the taxpayer would be deemed to have used the vacation home for personal purposes for a day if, for any part of the day the home is used by a co-owner or a holder of any interest in the home (other than a security interest or an interest under a lease for a fair rental) for personal purposes. For this purpose, any other ownership interest existing at the time the taxpayer has an interest in the vacation home shall be taken into account even if there are no immediate rights to possession and enjoyment of the vacation home under such other interest.

A taxpayer would not be considered to have personally used a vacation home with respect to a use by his employee, even if it is rented for less than a fair rental, if the value of such use is excludable from income by the employee under section 119 of the code (relating to meals and lodging furnished for the convenience of an employer). Further, if the taxpayer spends a normal work day cleaning, painting, repairing or otherwise maintaining the vacation home, such use shall not be treated as personal use.

For purposes of this new provision, the term "vacation home" means a dwelling unit including a house, apartment, condominium, house trailer, boat, or similar property. The term would include any environs and outbuilding, such as a garage, which relate to the use of the dwelling unit for living accommodations. However, the term would not include that portion of a dwelling unit that is used exclusively as a hotel, motel, inn, or similar establishment.

In the case where there is any personal use of a vacation home during the taxpayer's taxable year, the expenses allocable to the rental of the vacation home will be limited to an amount which bears the same ratio to such expenses as the number of days the home is actually rented out for the year bears to the total number of days the home is actually used for all purposes during the year. However, the limitation upon allocable expenses would not apply to expenses such as interest or taxes which are allowable even if not attributable to the rental activity.

For purposes of this limitation, the personal use of a vacation home would be determined in accordance with the rules described above. However, for purposes of determining the relationship of rental days to total days of use, the number of rental'days would include any day for which the vacation home is rented for a fair rental even if the taxpayer is deemed to have personally used the home for that day. The period during which the vacation home is merely held out for rent would not be considered in determining the number of rental days for a taxable year.

The committee amendment is substantially the same as the House bill except in two respects. First, the committee amendment increases one of the tests relating to the determination of personal use from 5 percent to 10 percent of the number of days during the year for which the vacation home is rented. Also, in order to simplify the administration of the provision, the committee amendment provides for a nonrecognition rule in the case of either operating gain or operating loss where the vacation property is rented for less than one month.

Revenue effect

This provision will increase budget receipts by $184 million in fiscal year 1977, $201 million in fiscal year 1978, and $297 million in fiscal year 1981.

3. Deductions for Attending Foreign Conventions (sec. 602 of the bill and new sec. 274(h) of the Code)

Present law

Under present law, the deductibility of travel expenses paid or incurred to attend a foreign convention, seminar, or meeting is governed by the ordinary and necessary standard (secs. 162 and 212) and, in certain cases, the special disallowance rules provided under the entertainment expense provision (sec. 274(c).

Generally, to be deductible, travel expenses must be reasonable and necessary in the conduct of the taxpayer's trade or business and directly attributable to such trade or business. If a trip is primarily related to the taxpayer's business (and the special foreign travel allocation rules do not apply) the entire travel expenses (including food and lodging) to and from a destination are deductible. If a trip is primarily personal in nature, the transportation expenses to and from the destination are not deductible even if the taxpayer engages in business activities while at the destination.[1] However, expenses incurred while at the destination which are allocable to the taxpayer's trade or business are deductible even if the transportation expenses are not deductible.

For expenses incurred in attending a convention or other meeting to be deductible, there must be a sufficient relationship between the taxpayer's trade or business and his attendance so that he is benefiting or advancing the interests of his trade or business. Generally, deductibility depends upon the facts and circumstances of each particular case. If the convention is for purposes unrelated to the taxpayer's business, the travel expenses are not deductible. The Internal

[1] See *Patterson* v. *Thomas*, 289 F. 2d 108 (5th Cir., 1961) ; *Espandiar Kadivar*, T.C. Memo 1973–95 ; Rev. Rul. 74–292, 1974–1 C.B. 43.

Revenue Service has ruled that the test for allowance of deductions for convention expenses is met if the agenda of the convention or other meeting is so related to the taxpayer's position as to show that attendance was for business purposes.

If an individual travels away from home primarily to obtain education for which the expenses are deductible as trade or business expenses, the expenses for travel, meals, and lodging incurred while away from home are deductible. However, the portion of the travel expenses attributable to personal activities, such as sightseeing, is treated as a nondeductible personal or living expense. If the travel away from home is primarily personal, only the meals and lodging incurred during the time spent in participating in educational pursuits are deductible. Further, in the case of foreign travel to obtain education, deductions are subject to special allocation rules.

Expenses of travel outside the United States are deductible only to the extent allocable to the taxpayer's trade or business or income-producing activities if the travel is for more than one week or the time of travel outside the United States which is not attributable to the pursuit of the taxpayer's trade or business is 25 percent or more of the total time on such travel. (This allocation requirement, if applicable, overrides the general rule that the entire expenses of travel are deductible if the primary purpose of the trip was related to a trade or business.)

Reasons for change

Serious administrative problems have arisen because of the recent proliferation of conventions, educational seminars, and cruises which are ostensibly held for business or educational purposes, but which it is believed are held at locations outside the United States primarily because of the recreational and sightseeing opportunities. In Technical Information Release 1275 (February 14, 1974), the Internal Revenue Service announced that it intended to scrutinize deductions for business trips, conventions, and cruises which appear to be vacations in disguise. The Service noted that a number of professional, business and trade organizations have been sponsoring cruises, trips and conventions during which only a small portion of time is devoted to business activity and that the practice seemed to be growing. In cases where there are indications of abuse, the Service intends to request lists of the names and addresses of the participants on cruises and other trips. However, allowance of deductions claimed by participants would continue to depend upon the facts and circumstances, including the relationship of the meeting to a particular taxpayer's trade or business, as under present law.

As indicated above, the basic test that is applied by the Internal Revenue Service is whether the convention or other meeting is primarily related to the taxpayer's business or whether it is primarily personal in nature. Thus, in administering this test, the Internal Revenue Service is required to make a subjective determination as to the motives and intentions of the taxpayer after taking into account all the facts and circumstances in a particular case. The administrative problems created by the lack of specific guidelines are substantial.

The committee is concerned that the lack of specific requirements has resulted in a proliferation of foreign conventions, seminars, cruises, etc. which, in effect, amount to Government-subsidized vacations and serve little, if any, business purpose. The committee is aware that the promotional material often highlights the deductibility of the expenses incurred in attending a foreign convention or seminar and, in some cases, describes the meeting in such terms as a "tax-paid vacation" in a "glorious" location. In addition, the committee has been made aware that there are organizations that advertise that they will find a convention for the taxpayer to attend in any part of the world at any given time of the year. This type of promotion has an adverse impact on public confidence in the fairness of the tax laws.

Nevertheless, the committee recognizes that in some cases it is reasonable for an organization to sponsor a meeting of its members outside the United States. For example, the purposes and activities of the meeting might relate peculiarly to a certain geographical location outside the United States so that the only reasonable place to hold the meeting is that location. Also, where the residences of the members of an organization are widely dispersed, it is reasonable to expect that some of the meetings be held at various locations for the convenience of the members.

Explanation of provision

The committee amendment adds a new provision (sec. 302) which, in general, provides that no deduction is to be allowed for expenses allocable to a convention, seminar or other meeting held outside the North American area unless, taking certain factors into account, it is more reasonable for the meeting to be held outside the North American area than within it. Generally, this requirement would be satisfied if the application of these factors demonstrated a compelling need to hold the meeting outside the North American area.

The factors to be taken into account are: (1) the purpose of the meeting and the activities taking place at the meeting; (2) the purposes and activities of the sponsoring organizations or groups; and (3) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organizations or groups have been or will be held.

With respect to the first factor, the purpose of the meeting must be related to a matter which involves international considerations (such as international trade), or a matter that can be explained or demonstrated in the most effective manner at a particular location outside the North American area because of the existence of certain unique facilities or circumstances (e.g., an archaelogical convention held in the proximity of a discovery site which is the principal discussion topic of the convention. Moreover, the activities taking place at the meeting must be consistent with these purposes. The activities would not be considered to be consistent with the purposes of the meeting if a significant portion of the meeting is devoted to extraneous matters or to social or recreational activities.

With respect to the second factor, the purposes and activities of the sponsoring organizations or groups must be related to the purpose and substance of the meeting. Thus, the reasonableness requirement will not be satisfied with respect to a business convention sponsored by a travel agency or any other sponsor whose organizational purposes are not directly related to the substance of the meeting. The organizational purposes may be determined by reference to the purposes of an identifiable unit or division of the entire organization, e.g., an international section of a domestic trade association.

With respect to the third factor, the reasonableness requirement will not ordinarily be satisfied if the meeting is held by an organization whose active membership consists entirely of residents of the United States. Generally, the reasonableness requirement would be satisfied if, after a favorable application of the other factors, the sponsor of the meeting is an organization which draws from foreign members and the number and location of its foreign meetings are reasonable in light of the number of foreign members and their geographical dispersion. For purposes of the consideration of this factor, the places at which other meetings of the sponsoring organizations or groups have been held or will be held will be taken into account.

In no case would the reasonableness requirement be satisfied if any portion of the convention, seminar, or other meeting is conducted on board a vessel. Thus, for example, a seminar conducted in connection with a cruise would not satisfy this requirement. A cruise ship means any vessel whether sailing within or without the territorial waters of the United States. However, it is not intended that a vessel that has been "retired" from use for cruises or other transportation and converted to hotel or other stationary use be subject to this strict denial of deductions.

The expenses allocable to the meeting would include tuition, registration fees, and similar charges paid or incurred in connection with attending the meeting as well as the allocable travel expenses. The amount of travel expense allocable to the meeting would be determined in a manner similar to the determination of travel expenses allocable to a trade or business activity under the existing regulations under section 274(c) of the code. However, if a taxpayer engages in other business activities during the trip, the expenses directly attributable to the business activities are not to be considered allocable to the meeting. For purposes of the existing foreign travel allocation rules, attendance at a meeting outside the North American area is to be considered as an activity not in pursuit of a trade or business and not in pursuit of an activity described in section 212 if the deductions allocable to the meetings are disallowed under this new provision.

For purposes of this new provision, the term "North American area" means the United States, its possessions, and the area lying west of the thirtieth meridian west of Greenwich, east of the internationai dateline, and north of the Equator, but not including any country of South America.

This provision would apply to an individual who attends a convention, seminar, or other meeting and to his employer or client where the allocable expenses are incurred by the employer or client under an advance, reimbursement, or other arrangement with the individual. The provision would not apply to an employee of the sponsoring organization who does not attend the convention, seminar or other meeting as a participant in the business or educational proceedings of the meeting. Thus, an individual who merely provided services in connection with furnishing meals and lodging to the participants of the meeting would not be subject to the new requirements of this provision. Further, unlike the existing foreign travel disallowance rules, the new provision would apply even if the travel away from home does not exceed one week or the personal travel is less than 25 percent of the total foreign travel time.

The taxpayer, as under present law, must also establish that the convention, seminar or other meeting is directly related to the active conduct of his trade or business (or to an activity described in section 212, e.g., an activity relating to the production of income). For this purpose, a convention, seminar or other meeting would not be considered to be directly related to a taxpayer's trade or business or income-producing activities merely because the taxpayer had a general expectation that his attendance would benefit or advance his trade or business or income producing activities. Thus, the taxpayer must establish that the subject matter and purposes of the meeting are specifically relevant to the activities in which he is presently and substantially engaged, including a specialized activity within a general line of business or professional practice.

Under the House bill, a limitation would be imposed on deductions allowable for the expenses of taxpayers attending conventions, educational seminars, or other meetings outside the United States and its possessions. Deductions would be allowed for expenses incurred in attending not more than two foreign conventions per year. For these two conventions, the amount of the deduction for transportation expenses could not exceed the cost of airfare based on coach or economy class. Transportation expenses would be deductible in full only if more than one-half of the total days of the trip (excluding the days of transportation to and from the site of the convention) are devoted to business-related activities. If less than one-half of the total days of the trip are devoted to business related activities, no deduction would be allowed for that portion of the transportation expenses attributable to non-business-related activities.

In addition, deductions for subsistence expenses, such as meals, lodging, and other ordinary and necessary expenses, paid or incurred while attending the convention would be limited to the fixed amount of per diem allowed to government employees at the location where the convention is held. However, in order to be able to deduct subsistence expenses up to this limitation, there must generally be at least 6 hours of business-related activities scheduled daily and the taxpayer must have attended two-thirds of these activities.

The committee believed that the House bill limitation of allowing deductions for the expenses of attending not more than two foreign conventions per year was, in certain cases, too generous in not requiring a showing of need to hold the convention abroad. On the other hand, the committee did not see the desirability of limiting the amount which could be deducted (except as provided by present law) where this need is shown.

Effective date

Generally, this provision is to apply to meetings held after December 31, 1976. However, the provision shall not apply to any trip which begins before January 1, 1978 if it is established (in advance of the beginning of the trip) that the meeting was publicly announced before January 1, 1976 and that accommodations for the meeting were booked before January 1, 1976.

Revenue effect

It is estimated that this provision will result in an increase in budget receipts of less than $5 million annually.

4. Qualified Stock Options (sec. 603 of the bill and secs. 422 and 424 of the Code)

Present law

An employee stock option is a right, which is limited in time, granted by a corporate employer to one or more employees to purchase a stated amount of stock in the corporation at a stated price. An option is a relatively low risk means of acquiring an equity interest in a corporation, since the option need not be exercised unless the value of the stock increases during the option period. If the value of the stock drops below the price at which the stock may be purchased (i.e., below the option price), the employee can allow the option to lapse (although ordinarily the employee would lose the amount which he may have originally paid for the option, if any).

Under present law, employee stock options fall broadly into two categories: "qualified" and nonqualified options. The former category is governed by statutory rules which set forth conditions which the option must meet in order to receive the favorable tax treatment accorded "qualified" stock options under present law. Employee options which do not satisfy these requirements (often called "non-qualified" or "nonstatutory" options) are governed by rules set forth in the income tax regulations (Regs. § 1.421–6) and by certain statutory rules which apply generally to property transferred to employees in connection with their performance of services (sec. 83).

Under present law, no income is recognized on the grant to a corporate employee, or on his exercise of, a "qualified" option to receive stock in the employer corporation (sec. 421). The stock acquired by the exercise of the option is a capital asset in the hands of the employee and the income realized from the eventual sale of the stock is generally treated as long-term capital gain or loss.[1]

No deduction is available to the employer, as a business expense (under sec. 162) with respect to either the granting of a qualified stock option or the transfer of stock to the employee when he exercises a qualified option.

A qualified option (meeting the requirements in sec. 422) must be granted pursuant to a plan approved by the shareholders of the corporation. The option must, by its terms, be exercised within 5 years from the date it is granted and the purchase price of the shares (option price) may not be less than the fair market value of the company's stock on the date when the option is granted to the employee. In addi-

[1] Generally similar tax treatment is also available in the case of "restricted" stock options, which were the predecessors to qualified options, but restricted stock options are no longer being granted, and most restricted options which were granted in the past have now been exercised or have lapsed.

tion, any stock acquired under a qualified option may not be disposed of within 3 years after it is transferred to the employee. The option must also be exercised while the option holder is an employee of the corporation, or within three months after the termination of his employment.

By contrast, nonqualified stock options are generally subject to the rules of section 83. Generally, under section 83, the value of a nonqualified stock option constitutes ordinary income to the employee if the option itself had a readily ascertainable fair market value at the time it was granted to the employee. If the option did not have a readily ascertainable value when granted, it would not constitute ordinary income at the time it was granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee.

As can be seen from the above description, qualified options have the advantage that an executive is not required to pay any ordinary income tax on the value of the option as such when the company grants it to him, or on any "bargain element" which may exist if and when he decides to exercise the option and purchase stock in the company. (The bargain element is the excess of the fair market value of a share of stock over its purchase price.) The employee is only required to pay tax when he sells the shares purchased under the option. Further, if he holds the shares for at least 3 years (as required for the option to remain qualified) he is entitled to pay tax at capital gain rates on the full amount of his gain (if any) over the price which he originally paid to buy the shares.

Although an employee does not have to pay tax under the qualified stock option rules at the time he exercises the option and receives stock worth more than he paid for it, the bargain element is treated as an item of tax preference under present law. This means that the excess of the fair market value of the share at the time of exercise over the purchase price paid by the employee is subject to the 10-percent minimum tax under present law (sec. 57(a)(6)).

Reasons for change

The principal reason for the present tax treatment of qualified stock options is said to be that such treatment allows corporate employers to provide "incentives" to key employees by enabling these employees to obtain an equity interest in the corporation. However, it seems doubtful whether a qualified stock option gives key employees more incentive than does any other form of compensation, especially since the value of compensation in the form of a qualified option is subject to the uncertainties of the stock market. Moreover, even to the extent a qualified option is an incentive, it still represents compensation and the committee believes that as such it should be subject to tax in much the same manner as other compensation. Moreover, to the extent that there is an incentive effect resulting from stock options, it could be argued that present law discriminates in favor of corporations (which are the only kind of employers who can grant qualified options) as opposed to all other forms of business organization.

The committee amendment is essentially the same as the House bill except for a provision (which it expects will be used primarily by new business ventures) permitting an employee, at his election, to require that an option be valued at the time it is granted (regardless of the difficulty of ascertaining a fair market value at that time).

Explanation of provisions

Under the committee amendment, present law will not apply to qualified stock options granted after May 20, 1976, except in the case of an option granted under a written plan adopted and approved on or before that date, or under a plan adopted by a board of directors on or before May 20, 1976 (even if the plan is approved by the shareholders after that date).

Thus, generally, stock options granted after May 20, 1976, whether or not qualified (under the requirements of section 422) will be subject to the rules which apply today in the case of most nonqualified options granted after June 30, 1969 (sec. 83 of the code). Under these rules, if an employee receives an option which has a readily ascertainable fair market value at the time its is granted, this value (less the price paid for the option, if any) constitutes ordinary income to the employee at that time.[2]

On the other hand, if the option does not have a readily ascertainable fair market value at the time it is granted, the value of the option does not constitute income to the employee at that time, but would be taxable to the employee when the option is exercised. The ordinary income recognized at that time is the spread between the option price and the value of the stock (unless the stock is nontransferable and subject to a substantial risk of forfeiture).

Any option which is subject to the provisions outlined above (sec. 83) is not treated as a tax preference for purposes of the minimum tax.

To illustrate these rules, consider the case of a qualified option granted to a corporate executive to buy 100 shares at $10 per share. The employee exercises the option in full when the shares are selling at $15 per share in the open market. Under the committee amendment, this transaction would be treated (under sec. 83) as follows:

(a) At the time that the company grants the option to the executive, if the option as such has a readily ascertainable fair market value, the value of the option (less any amount which he may have been paid for it) is taxable to the executive as ordinary income.

(b) If the option itself does not have a readily ascertainable market value, the executive will be subject to tax when he exercises the option and acquires the shares under option to him. In this example, the employee will be taxable on the $5 per share bargain element (or a total of $500) at the time he exercises his option. This income will be treated as compensation taxable at ordinary income rates.[3]

[2] However, if the option was nontransferable and was also subject to a substantial risk of forfeiture, recognition of income would be postponed until one or both of these encumbrances is removed.

[3] As indicated above, recognition of income could be postponed if the stock is not transferable and if it is subject to a substantial risk of forfeiture. In this case, the tax is imposed (at ordinary income rates) at the time when either of these two restrictions is removed and the tax base is the excess of the fair market value of the shares at the time when either of these two restrictions is removed over the amount which the employee originally paid for the property. However, under section 83, an employee who receives stock (or other property) in his employer corporation burdened by restrictions which would free him from paying a tax at that time may, nevertheless, elect to pay tax on the bargain element existing at that time. If the employee makes this election and pays tax when he exercises the option, any later increase in value of the shares will generally be taxable to him as capital gain (rather than compensation income) when he disposes of the shares.

Income recognized by the employee under these rules would generally constitute earned income for purposes of the maximum tax on earned income (sec. 1348).

(c) After the executive pays tax at ordinary income rates on the compensation portion of the transaction, he would be entitled to add the amount of ordinary income recognized to his basis in the shares. Any further gain (realized when the employee sells the shares) would generally be taxable as a capital gain.

(d) The employer corporation is entitled to a deduction (under sec. 83) in an amount equal to the ordinary income realized by an employee under the above rules. The employer's deduction accrues at the time that the employee is considered to have realized compensation income.

The rules outlined above are not to apply to employee "stock purchase plans" (described in sec. 423 of the Code) under which the rank and file employees of a corporation (as well as the executives) are afforded an opportunity to purchase corporate stock on a nondiscriminatory basis. The present Federal tax treatment of this type of plan is not affected by the committee amendment.

The committee amendment also provides certain transition rules so as not to disturb arrangements which were entered into in reliance on present law. Under the transition rules, present law will continue to govern qualified stock options granted pursuant to a written qualified stock option plan which was adopted by the board of directors of the corporation before May 21, 1976. For purposes of this rule, it is immaterial whether the shareholders approve the plan before, on, or after that date, although in order to be a qualified plan the shareholders must approve the plan within 12 months before or after its adoption by the board (sec. 422(b)(1)). In order to retain its qualification the option must be exercised by the employee before May 21, 1981 (i.e., within five years of the May 20, 1976 cutoff date). However, this requirement does not have to be spelled out under the terms of the option; it is sufficient if the option is actually exercised on or before May 20, 1981.

In general, a plan is to be treated as having been "adopted" by the board of directors of the corporation by May 20, 1976, only if all of the action required for adoption has been completed by that date. For example, if the plan had been adopted by the directors of a corporation under procedures which were valid under State law, the plan would generally be treated as having been "adopted" within the meaning of the statute. For purposes of these rules, any amendment of an existing plan to increase the number of shares which may be granted under the plan is to be treated as a new plan. Thus options granted as a result of a plan amendment adopted after May 20, 1976, would not be qualified options. It is not necessary, however, in the case of a plan adopted by May 20, 1976, for options to have been granted under the plan by that date or for the directors or shareholders to have authorized the specific grant of options under the plan to specific individuals.

If qualified options are granted under the transition rule, but the options are not exercised until after May 20, 1981, the committee intends that the option is to be treated as an option which did not have a readily ascertainable fair market value at the time it was granted (within the meaning of sec. 83(e)(3)). Thus, the value of the option in this case would not constitute income to the employee when granted (or at a time the transition rule expires), but if the option subsequently is exercised, and if the fair market value of the stock exceeds the option price, this excess will constitute ordinary income to the employee at the time of exercise.

The committee amendment also requires that all outstanding restricted stock options (sec. 424) must be exercised on or before May 20, 1981, in order to receive the Federal tax treatment currently accorded these options.

As under present law, in the event of a corporate merger, consolidation or other reorganization, the employer corporation may substitute a new option for an old option, as long as the new option and the old option are substantially equivalent (sec. 425). Thus the surviving corporation in a corporate merger could substitute options on its stock for options on the stock of the nonsurviving corporation, so long as the options were of equivalent value and the new option did not provide for any additional benefits for the employee which he did not have under the old option. These substitutions can occur after May 20, 1976, on the same basis as before that date. (Of course, "old options" could not be granted after May 20, 1976, by the acquired corporation, except as provided under the transition rules. However, if a corporation adopted an option plan in 1974 and is reorganized in 1977 into a holding company with one or more operating subsidiaries, the holding company may adopt the 1974 option plan and continue to grant qualified stock options to the extent permissible had the reorganization not occurred.)

The committee amendment also adds a new provision (which will probably be used, for the most part, by new business ventures) which allows an employee to elect early valuation of an option which does not have a readily ascertainable fair market value at the time it is granted. Under present law, as indicated above, tax would be postponed on a nonqualified option which does not have a readily ascertainable fair market value until the option is actually exercised. At that time, however, tax would be imposed at ordinary income rates, on the excess of the fair market value of the stock over the option price.

Under the committee amendment, the employee could elect to treat the value of the option as ordinary income. The amount taken into income would be added to the employee's basis, and any gain ultimately realized upon the sale of the stock would generally be taxed at capital gain rates.

Of course, merely because the option is difficult to value does not mean that the option has no value. The value would have to be determined under all the facts and circumstances of the particular case. Among other factors to be taken into account would be the length of the option period (the longer the period, the greater the chance that the underlying stock might increase in value), the earnings potential of the corporation, and the success (or lack of success) of similar ventures. Corporate assets, including patents, trade secrets and know-how would also have to be taken into account.

Effective date

The amendments with respect to qualified stock options apply to taxable years ending after May 20, 1976. The provision allowing an employee to elect early valuation of an option applies to options granted after the date of enactment in taxable years ending after that date.

Revenue effect

This provision will increase budget receipts by $7 million in fiscal year 1977, $20 million in fiscal year 1978, and $5 million in fiscal year 1981.

5. Legislators Travel Expenses Away From Home (sec. 604 of the bill and sec. 162 of the Code)

Present law

Under present law, an individual is allowed a deduction for traveling expenses (including amounts expended for meals and lodging) while away from home in the pursuit of a trade or business (sec. 162 (a)). These expenses are deductible only if they are reasonable and necessary in the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable deductions. In addition, no deductions are allowed for personal, living, and family expenses except as expressly allowed under the code (sec. 262).

Generally, under section 262, expenses and losses attributable to a dwelling unit which is occupied by a taxpayer as his personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions of the tax laws (secs. 163, 164, and 165).

A taxpayer's "home" for purposes of the deduction for traveling expenses generally means his principal place of business or employment. Where a taxpayer has more than one trade or business, or a single trade or business which requires him to spend a substantial amount of time at two or more localities, his "home" is held to be at his principal place of business. A taxpayer's principal place of business is determined on an objective basis taking into account the facts and circumstances in each case. The more important factors to be considered in determining the taxpayer's principal place of business (or tax home) are: (1) the total time ordinarily spent by the taxpayer at each of his business posts, (2) the degree of business activity at each location, (3) the amount of income derived from each location, and (4) other significant contacts of the taxpayer at each location. No one factor is determinative.

In 1952, a provision was adopted with respect to the living expenses paid or incurred by a Member of Congress (including a Delegate or Resident Commissioner). Under these rules, the place of residence of a Member of Congress within the congressional district which he represents in Congress is considered his tax home. However, amounts expended by the Member within each taxable year for living expenses are not deductible in excess of $3,000. Therefore, a Member of Congress (who does not commute on a daily basis from his congressional district)[1] can deduct up to $3,000 of his expenses of living in the Washington, D.C. area.

These special rules do not apply in the case of a State legislator. As a result, the tax home of a State legislator is determined in accordance with the general rules described above. In a situation where a State's legislature is in session for a significant portion of the year, that State's legislators' homes, may, under these rules, be at the State capital rather than in their legislative districts.

Reasons for change

In recent years, the sessions of many State legislatures have been substantially lengthened. As a result, members of the various legislatures are required to spend substantial portions of each year in the State capital. In order to reimburse the legislators for the living expenses incurred in connection with attending sessions in the State capital, many legislatures provide a per diem for each day a legislator attends a session of the legislature.

It is extremely difficult for many State legislators to determine their tax homes under the facts and circumstances test of present law. First the length of time that a State legislature is in session may vary substantially from year to year. Moreover, several State legislatures meet only once every two years. In addition to the variation of time, a legislator's income derived from his place of residence and from the State capital will frequently vary. This problem is heightened by the fact that the Internal Revenue Service will not issue an advance ruling determining an individual legislator's tax home.

Consistent with their prior practice, many State legislators have continued to treat their residences in the districts they represent as their tax homes and have filed their Federal income tax returns in accordance with this practice, thereby deducting living expenses incurred in the State capital. It has come to the committee's attention that the Service is currently challenging this practice and determining the tax home of a State legislator on a case-by-case basis. In some cases, this has resulted in a determination that the legislator's tax home is the State capital and in other cases, that his tax home is in the district that he represents. If the Service determines that a legislator's tax home is the State capital, deductions taken for living expenses incurred in connection with the time spent at the State capital are disallowed. Although a deduction will then be allowed for living expenses incurred in the district the State legislator represents, in many cases the taxpayer (having relied on prior practice) will not be able to substantiate those expenses. The committee feels that this inconsistent treatment has produced inequitable results for many State legislators.

For these reasons, the committee decided that the uncertainty of present law as to the tax "home" of a State legislator should be clarified by applying the same definitive rule that applies to Members of Congress. In addition, the committee feels that State legislators should be entitled to treatment similar to that presently accorded other businessmen. Under present law, if an employer reimburses an employee for subsistence or provides an employee with a per diem allowance in lieu of subsistence, the employee may generally deduct up to $44 per day for subsistence expenses incurred in connection with

[1] Under the "overnight rule," travel away from home expenses (as distinguished from transportation expenses) generally cannot be deducted unless the taxpayer is away from home on business overnight.

travel away from home (on behalf of his employer) without the requirement of substantiation.

The committee amendment is essentially the same as the House bill in the case of State legislators. The House bill also dealt with the tax treatment of Members of Congress by substituting for the $3,000 limitation under present law an amount to be determined by the Internal Revenue Service for living expenses away from home (that is, in Washington, D.C.) similar to that allowed for businessmen under similar circumstances. The committee amendment deleted this provision in the House bill relating to Members of Congress.

Explanation of provision

The committee's amendment provides that the tax home of a State legislator for purposes of the deduction for trade or business expended in connection with his trade or business as a legislator, is to be the place of residence of the State legislator within the district he represents. The amendment, however, provides a dollar limitation on the amounts that are to be allowable as a deduction in connection with living expenses paid or incurred while away from home along the lines of the limitation imposed upon business employees generaly. In general, the dollar limitations are to be established by the Bureau of Labor Statistics for each calendar year by applying rules of reasonableness and taking certain factors into account.

In the case of a State legislator, the Bureau of Labor Statistics is to determine a dollar limitation on a State-by-State basis for each day of legislative participation. The factors to be taken into account are: (1) the cost of living during the calendar year in the place where the legislature meets and (2) amounts normally allowed as business expenses of businessmen under similar circumstances. Deductions are not to exceed the daily amount so established, multiplied by the total number of days of legislative participation by the State legislator during the calendar year. For this purpose, a day of legislative participation is to include each day that the legislator's physical presence is formally recorded during a meeting of the State legislature or a meeting of a committee of the State legislature.

This provision is essentially the same as the House bill except that under the committee amendment, the Bureau of Labor Statistics rather than the Internal Revenue Service would determine the dollar limitations on the amount allowed as a deduction.

Because of the uncertainty under present law with respect to the tax home of State legislators, the committee also decided to provide an election for the tax treatment for certain prior taxable years. Under this election, a State legislator may, for this period, treat his place of residence within his legislative district as his tax home for purposes of computing the deduction for living expenses. If this election is made, the legislator will be treated as having expended for living expenses an amount equal to the sum of the daily amount of per diem generally allowed to employees of the U.S. government for traveling away from home, multiplied by the number of days during that year that the State legislature was in session, including any day in which the legislature was in recess for a period of four or less consecutive days. In addition, if the State legislature was in recess for more than four consecutive days, a State legislator may count each day in which his physical presence was formally recorded at a meeting of a committee of the State legislature. For this purpose, the rate of per diem to be used is to be the rate that was in effect during the period for which the deduction was claimed. In addition, the total amount of deductions allowable pursuant to this election is not to exceed the amount already claimed under a Federal income tax return filed by a State legislator before May 21, 1976. For this purpose, amounts shall be considered claimed under a return even though the taxpayer treated his living expenses as an offset against any reimbursement of per diem he received from the State legislature and, therefore, did not actually set forth these expenses as a deduction on his income tax return. The election is to be made at such time and in such manner as provided under Treasury regulations.

These limitations are to apply only with respect to living expenses incurred in connection with the trade or business of being a legislator. The committee amendment does not impose a limitation on living expenses incurred by a legislator in connection with a trade or business other than that of being a legislator. As to other trade or businesses, the ordinary and necessary test of present law will continue to apply.

The committee amendment as to prior taxable years is essentially the same as the House bill except that in determining the total number of days of legislative particpation, the committee amendment includes any day in which the legislature was in recess for 4 or less consecutive days.

The committee amendment deleted the provision contained in the House bill which would have removed the $3,000 limitation for Members of Congress and replace it with a limitation similar to that for State legislators.

Effective dates

These provisions are to apply to taxable years beginning after December 31, 1975. However, the provision relating to the election of State legislators shall apply to all taxable years beginning on or before December 31, 1975, for which the period of assessing or collecting a deficiency has not expired before the date of enactment of this bill.

Revenue effect

The revenue impact of this provision cannot be estimated until the Bureau of Labor Statistics determines the deduction level.

6. Treatment of losses from certain nonbusiness guarantees

The House bill contained a provision which treats a taxpayer who has a loss arising from the guarantee of a loan in the same manner as where he has a loss from a loan which he makes directly. Thus, if the guarantee agreement arose out of the guarantor's trade or business, the guarantor would still be permitted to treat the loss as an ordinary loss. If the guarantee agreement were a transaction entered into for profit by the guarantor (but not as a part of his trade or business), the loss would be treated as a short-term capital loss. This rule, under the House bill, also would apply in the case of a guarantor of a corporate obligation.

The committee amendment deletes this provision in the House bill because the committee was concerned about its effect on small businesses.

G. ACCUMULATION TRUSTS

(Sec. 701 of the bill and secs. 644 and 665–669 of the Code)

Present law

A trust is generally treated as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiary as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

Present law provides that beneficiaries are taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust.

This is referred to as the throwback rule under which distributions of accumulated income to beneficiaries are thrown back to the year in which they would have been taxed to the beneficiary if they had been distributed currently. The Tax Reform Act of 1969 revised the prior throwback rule to provide an unlimited throwback rule with respect to accumulation distributions.

The tax on accumulation distributions is computed in either of two ways. One method is the "exact" method, and the other is a "shortcut" method which does not require the more extensive computations required by the exact method. Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years when earned. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust and the taxes of the beneficiary can be determined for each year. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary is allowed a credit for his share of the taxes paid by the trust. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect determines the tax attributable to the distribution by averaging the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 3 immediately prior years. The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust.

Capital gain throwback rule.—Present law provides an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision normally does not apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their income currently, until the first year they accumulate income. For purposes of this provision, a capital gains distribution is deemed to have been made only when the distribution is greater than all of the accumulated ordinary income. If the trust has no accumulated ordinary income or capital gains, or if the distribution is greater than the ordinary income or capital gain accumulations, then to this extent it is considered a distribution of corpus and no additional tax is imposed.

Reasons for change

The progressive tax rate structure for individuals is avoided if a grantor creates a trust to accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

The throwback rule (as amended by the Tax Reform Act of 1969) theoretically prevents this result by taxing beneficiaries on distributions they receive from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. The 1969 Act made a number of significant revisions in the treatment of accumulation trusts. In applying the throwback rule to beneficiaries with respect to the accumulation distributions they receive, the Act provided two alternative methods, as indicated above, the exact method and the shortcut method. A number of administrative problems have resulted in the application of these alternative methods for both the Internal Revenue Service and the beneficiaries.

For example, trustees are under an obligation to the beneficiaries of the trust to compute the throwback under the rule which results in the least tax; thus, the shortcut method, which was intended to simplify calculations and eliminate recordkeeping problems involved with the exact method has not achieved this result because trustees must compute the tax under both methods. As a result, the committee believes it is more desirable to have one simplified method rather than having two alternative methods in applying the throwback rule. In the case of multiple trusts, however, the committee is concerned about the potential tax avoidance use of such trusts. As a result, the committee amendment provides a special rule in the case of accumulation distributions received by any beneficiary from three or more trusts.

In addition, the committee is aware that a number of questions have been raised as to whether the capital gains throwback rule, which was enacted in the 1969 Act, presents more complexity in its application than is warranted by the concerns raised in 1969 with respect to capital gains. The committee believes it is appropriate to repeal the capital gains throwback rule and provide instead a rule to deal more directly with the transferring of appreciated assets by grantors into trusts.

The committee has also reviewed other aspects of the tax treatment of accumulation trusts and provided modifications to make the rules easier to apply and be administered. For example, the committee amendment provides an exemption for the income accumulated in a trust during the minority of a beneficiary, as was provided in the law under the throwback rule before 1969.

Explanation of provision

The committee amendment substitutes for the two alternative methods used in computing the throwback rule for accumulation distributions a single method, which is a revision of the present "shortcut" method. The new shortcut method provided under the committee amendment determines (in effect) the tax attributable to the distribution by averaging the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 5 preceding years (rather than the 3 preceding years under present law).[1] The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust (as determined under present law). This average amount is added to the beneficiary's taxable income for these years (rather than requiring the recomputation of his tax returns as under present law).[2]

Of these 5 preceding years, the year with the highest taxable income and the year with the lowest would not be considered; in effect, then, the computation of the additional tax on the accumulation distribution under this shortcut method is based, as under present law, on a 3-year average basis.

In general, except as indicated below, the present rules under the shortcut method continue to apply. Thus, if the accumulated income is attributable to 10 different years (although the trust may have been in existence longer than 10 years) then one-tenth of the amount distributed would be added to the beneficiary's taxable income in each of the 3 years. The additional tax is then computed with respect to these 3 years and the average yearly additional tax for the 3-year period is determined. This amount is then multiplied by the number of

[1] The accumulated income which is to be included in the beneficiary's income for any year under the shortcut method is the income of the trust which would have been included in the beneficiary's income if the trust had made the distributions currently rather than accumulating the income. As a result, the character of any tax-exempt interest would be carried with the accumulated income and, thus, would not be subject to tax to the beneficiary.

[2] For purposes of adding the accumulated income to the taxable income of a beneficiary for a year, the beneficiary's taxable income may not be less than zero. Thus, if in any year to which the shortcut method applies a beneficiary has a net operating loss, the beneficiary's taxable income for that particular year will be treated as being zero.

years to which the trust income relates (10 in this example). The tax so computed may be offset by a credit for any taxes previously paid by the trust with respect to this income and any remaining tax liability is then due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution. Under the committee amendment, no refunds or credits are to be made to any beneficiary or a trust as a result of any accumulation distributions.

The committee amendment provides a special rule to deal with multiple trusts where a beneficiary receives an accumulation distribution from more than two trusts with respect to the same year. Under this rule, in the case of a distribution from the third trust (and any additional trusts), the beneficiary is to recompute his tax under the revised shortcut method in the same manner as indicated above except that no credit is to be given for any taxes previously paid by the trust with respect to this income. The committee amendment provides a *de minimis* rule under which this special multiple trust rule is not to apply. Under this *de minimis* rule, the special multiple trust rule is not to apply where an accumulation distribution from a trust (including all prior accumulation distributions from the trust to the beneficiary for that same year) is less than $1,000.

The committee amendment provides that the throwback rule is not to apply to any distributions of income accumulated for a beneficiary while he was a minor; that is, before the birth of such beneficiary or before the beneficiary is 21 years of age. This exception for minors, however, is not to apply in the case of distributions covered under the multiple trust rule.

The committee amendment also modifies the present rules in determining when an accumulation distribution is made. Under present law, if a trust has deductions taken into account in determining distributable net income, for example, fees which are chargeable to corpus, the trust accounting income (as defined under section 643(b)) will exceed the distributable net income of the trust. In this case a distribution of the current year's trust income to a beneficiary, which otherwise is technically the accounting income of the trust for the year, is treated as constituting an accumulation distribution of the trust. To deal with this situation, the committee amendment provides a rule that a distribution made or required to be distributed by a trust to a beneficiary in a year which does not exceed the income of the trust for the year is not to be treated as an accumulation distribution for that year.

The House bill is the same as the committee amendment with respect to these revisions of the throwback rule.

The committee amendment also repeals the capital gain throwback rule under present law. The committee amendment, however, provides a special rule to cover the possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure (sec. 644). Under this rule, where the fair market value of property which is placed in trust exceeds the price paid (if any) for the property by the trust (i.e., where there is any bargain element in connection with the transfer) and the trust sells the property within two years of its transfer to the trust, the tax on the gain (called the "includible gain") to the trust will be equal to the amount of additional tax the transferor would have paid (including any minimum tax[3]) had the gain been included in the gross income of the transferor for his taxable year in which the sale occurred. In essence, the committee amendment treats such gains as if the transferor had realized the gain and then transferred the net proceeds from the sale after tax to the trust is corpus.

However, where the transferor before the sale dies within the two-year period so that it would not be possible to use the rate brackets of the transferor, the bill makes the provision inapplicable. Consequently, in such a case, the tax on the gain would be taxed at the trust's rates. In order to prevent circumvention of the two-year period through a short sale during such period, the bill also contains a rule which extends two-year period to the closing of the short sale.

For purposes of determining whether the property is a capital asset subject to favorable capital gains treatment, the bill contains a rule under which the character of the property is to be determined by looking to the character of that property in the hands of the transferor. Consequently, where section 644 applies, the gain on the sale of the property will not be entitled to capital gains treatment if the property would not have been a capital asset in the hands of the transferor even if the property is a capital asset in the hands of the trust. In addition, the bill contains a rule which attributes the activities of the trust with respect to the property to the transferor for this purpose. In effect, the provision treats the trust as the agent of the transferor so that the trust's activities are attributed to the transferor.

The "includible gain" is the lesser of the amount of gain recognized by the trust or the amount of gain that the trust would have realized had the property been sold immediately after it was transferred to the trust.[4] Therefore, the transferor cannot use the trust's lower progressive rate structure to tax gain that occurred while he owned the property. Any additional gain that occurs after the property is transferred to the trust is subject to the normal rules for gains realized by the trust.

In order to prevent double taxation of the "includible gain", the committee amendment excludes the includible gain from the taxable income of the trust. Thus, the tax on the remaining income of the trust (including additional gain on the property occurring after the transfer to the trust) will be computed without regard to that includible gain. Similarly, since the "includible gain" is excluded from the trust's taxable income, that gain is not included in the trust's distributable net income and, consequently, the includible gain also will not be taxed to the beneficiary if the gain is currently distributed to him. Moreover, since the includible gain is not in the trust's distributable net income, that gain will not be subject to the accumulation distribution rules

[3] For purposes of computing the minimum income tax portion of the section 644 tax, the amount of tax paid by the transferor shall be deemed to include the tax determined under section 644 other than the portion attributable to the application of the minimum income tax.

[4] Under the committee amendment, the basis of the property for purposes of determining the amount of the "includible gain" is the trust's basis immediately after its transfer to the trust. Consequently, this basis includes any increases in basis under section 1015(d) (relating to increased basis for gift tax paid). The bill also contains special rules where the trust sells the property within the two-year period and elects to report the gain on the installment sales method of accounting (sec. 453). In such a case, the provision, in essence, treats each installment as a sale or exchange to which the normal rules of section 644 apply.

(under subpart D) where the gain is first accumulated and then distributed in a subsequent year.

Where the trustee of the trust does not have sufficient information about the transferor to compute the tax on the includible gain, it is expected that the Internal Revenue Service will issue regulations under which the trustee will state in the tax return that he does not have sufficient information and that, in such a case, the Service will compute the tax attributable to that gain. It is also expected that the Service will issue regulations providing rules where the transferor's taxable income or tax is affected by subsequent events such as a loss carryback or adjustment by the Internal Revenue Service. The special rule on transfers of appreciated property is not to apply to property placed in charitable remainder trusts or pooled income funds or to property acquired by a trust from a decedent.

There will be some cases where, because the trust is on a fiscal year, it will not be possible for the trustee to ascertain the tax that the transferor would have paid had the transferor realized the gain because the sale occurs within a taxable year of the transferor which ends after the end of the taxable year of the trust in which the sale occurs. For example, assume that the transferor uses a calendar year and the trust uses a fiscal year ended June 30, the transferor transfers appreciated property to the trust in 1977, and the trustee sells the property during the first six months of calendar year 1978. In such a case, the tax return of the trust for the year in which the sale occurred (fiscal year ended June 30, 1978) is due on October 15, 1978. However, the tax return of the transferor for the year in which the sale occurred (calendar year 1978) is not due until April 15, 1979. In such a case, the bill provides a rule under which the trust will report the gain in its tax return due October 15, 1979, but the tax on the gain will be increased by an additional amount representing, in effect, the interest on the one-year delay in reporting the gain. Where the trust terminates during this one-year period, it is contemplated that the Treasury will issue rules making such gain reportable in the return of the trust for its last taxable year.

The House bill also provides for the repeal of the capital gain throwback rule. However, in its place, the House bill provides that the property transferred to the trust would have a 2-year holding period in order to qualify for long-term capital gain treatment with respect to the unrealized appreciation in the property at the time it is placed in trust. The committee amendment, as indicated above, taxes the appreciation to the trust at the grantor's rates rather than providing for a special 2-year holding period for capital gain treatment.

Effective date

The amendments made by this provision to the accumulation distribution rules are to apply generally to distributions made in taxable years beginning after December 31, 1975. In addition, a special rule has been added by the committee amendment to permit the revised accumulation distribution rules to apply to a distribution made before the general effective date of these amendments where the distribution occurred by reason of the Internal Revenue Service terminating the existence of the trust before the general effective date so long as the actual distribution occurs after the general effective date of these amendments. The amendment made with respect to the taxation of gain arising from sales of property within two years of its transfer in trust are to apply to transfers made after May 21, 1976.

Revenue effect

It is estimated that this provision will not have a significant effect on budget receipts.

H. CAPITAL FORMATION

1. Investment Tax Credit General (sec. 801 of the bill, sec. 46 and 48 of the Code, and sec. 301(c) of the Tax Reduction Act of 1975)

Present law

Present law provides a 10-percent investment credit for the period beginning January 22, 1975, and ending December 31, 1976. (For the period when the basic rate is 10 percent, a corporate taxpayer may elect an 11-percent credit if an amount equal to the additional one percent is contributed to an employee stock ownership plan.) Thereafter, the rate is to revert to 7 percent (4 percent with respect to certain public utility property). The investment credit is available for: (1) tangible personal property; (2) other tangible property (not including a building and structural components) which is an integral part of manufacturing production, etc., or which constitutes a research or storage facility; and (3) elevators and escalators. Generally, the credit is not available with respect to property used outside the United States.

To be eligible for the credit, the property must be depreciable property with a useful life of at least 3 years. Property with a useful life of 3 or 4 years qualifies for the credit to the extent of one-third of its cost; property with a useful life of 5 or 6 years qualifies with respect to two-thirds of its cost; and property with a useful life of 7 years or more qualifies for the credit to the full extent of the property's cost. (However, in the case of used property, not more than $50,000 of cost may by taken into account by a taxpayer as qualified investment for purposes of the credit for a taxable year. For 1975 and 1976, the $50,000 limit is increased to $100,000.)

Generally, property becomes eligible for the credit when it is placed in service. The investment credit is also available before the property is placed in service, as progress expenditures are made.

The amount of the credit that a taxpayer may take in any one year generally cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation cannot be used in the current year may be carried back 3 taxable years and then carried forward 7 taxable years and used in those years to the extent permissible within the limitations applicable in those years. (In the case of public utility property, the 50-percent limit is increased to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980. The limit reverts to 50 percent for 1981 and later years.)

Present law provides for a recapture of the investment credit to the extent property is disposed of before the end of the period which was used in determining the amount of the credit originally allowed. In these cases the tax for the current year is increased by the reductions in investment credits which would have resulted if the credit were computed on the basis of the actual useful life of the property rather than its estimated useful life.

Reasons for change

Since 1962, the investment tax credit has been changed seven times. Thus, the credit has been changed once every two years on average. In reviewing the composition of the current economic recovery, your committee has been concerned that investment in plant and equipment has been low and, when adjusted for price changes, actually declined in 1974 and 1975. Projections for 1976 indicate a possible increase in real investment; however, because most industries are still operating well below capacity, the immediate demand for investment may not be strong in 1976.

Long-run projections of the labor force indicate that substantial amounts of plant and equipment will be needed in the 1980's in order to provide the necessary capital to fully employ these additional workers. Also, because of various environmental regulations passed by the Congress, additional investment will be needed to met our environmental objectives.

To ensure that these long-run capital formation needs will be met as well as to provide some additional stimulus to investment now, your committee provides for a permanent extension of the 10-percent investment tax credit. In making the investment tax credit permanent, your committee intends to materially reduce the uncertainty surrounding the credit which may be currently limiting its effectiveness,

Explanation of provision

The committee amendment permanently extends the investment tax credit at a 10-percent rate and permanently increases from $50,000 to $100,000 the limit on the credit of investment in qualified used property. The House bill would have increased the investment tax credit to 10 percent and the limit on used property to $100,000 through 1980. Under the House bill, the credit would revert to 7 percent (4 percent in the case of certain public utilities) in 1981.

Effective date

The committee amendment becomes effective for taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $1,300 million in fiscal year 1977, $3,306 million in fiscal year 1978, and $3,814 million in fiscal year 1981.

2. Refunds of Unutilized Investment Tax Credits (sec. 802 of the bill and sec. 6201 and 6401 of the Code).

Present law

Under present law. the investment tax credit generally cannot in any taxable year exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of the $25,000. Investment tax credits which cannot be used because of this limitation may be carried back 3 taxable years and used in those years to the extent possible within the limitation and then carried forward 7 taxable years and used in those years within the limitation. (In the case of public utilities, the 50-percent limitation increases to 100 percent in 1975 and 1976, 90 percent in 1977, 80 percent in 1978, 70 percent in 1979, 60 percent in 1980, and 50 percent thereafter.)

Reasons for change

During the past several years, a significant number of taxpayers have experienced either losses or low incomes in relation to their sales. Yet, to remain competitive, they need to continue, or in some cases to increase, their levels of investment. Because of the particular pattern over time of their losses or low income, the current limitations on the investment tax credit would not permit many of them to fully utilize their credits. This in turn may reduce the effectiveness of the credit as an incentive for investment. Accordingly, your committee provides that unutilized investment tax credits earned in 1976 or later years, which, after the full application of the carryback and carryforwards of the credit are still unutilized, are to be refundable at the end of the carryforward period. Thus, credits arising in 1976, if not utilized in prior or subsequent years, are to the extent remaining unused to be refunded at the end of 1983.

Explanation of provision

The committee amendment provides that investment tax credits which are earned with respect to property which becomes eligible for the investment tax credit on or after January 1, 1976, and which cannot be used during the 3-year carryback and 7-year carryforward period are to be refundable at the expiration of the carryforward period. Thus, taxpayers who are unable to use investment tax credit resulting from investments in 1976, and over the next seven years (as well as the previous 3 years) will be entitled to a refund of such credits beginning in 1984.

The House bill does not contain a comparable provision.

Effective date

This amendment is effective with respect to credits earned after December 31, 1975.

Revenue effect

It is estimated that this provision will not affect revenues until 1984. In that year it is estimated that this provision will result in a reduction of $300–$500 million in revenues.

3. Expiring Investment and Foreign Tax Credits (sec. 803 of the bill and sec. 46 and 904 of the Code)

Present law

Under present law the investment tax credit for any year generally cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. If the amount of investment tax credit for any year exceeds the applicable limitation based on the amount of tax liability for that year, the excess is generally an investment credit carryback to each of the three preceding taxable years and an investment credit carryover to each of the seven following taxable years and, subject to certain limitations, is added to the amount allowable as a credit for those years (sec. 46(b)).[1] If any portion of a credit remains after application to the carryback and carryover periods, the unused portion expires and cannot be used subsequently by the taxpayer.

With respect to the foreign tax credit, current law provides, subject to certain limitations, for a two-year carryback and five-year carryforward of unutilized foreign tax credits (sec. 904). As in the case of the investment tax credit, any portion of a credit which remains unused after the application of the two-year carryback and five-year carryforward expires and cannot be used subsequently by the taxpayer.

Reasons for change

During 1970–1971 and 1974–1975 the economy suffered two serious recessions. Moreover, in certain industries the setbacks suffered in 1970 have continued through the past few years. Nonetheless, in order to remain competitive domestically and internationally, many firms in these industries have continued to invest in new plant and equipment in the U.S. and maintain their overseas business operations. In some cases, funds have been brought back from overseas to support domestic operations. However, where domestic operations have subsequently worsened and created net operating losses, these losses have often eliminated the domestic income in the earlier years and resulted in carryforwards of previously absorbed tax credits. The committee is concerned that the expiration of the carryforward period for both of these credits may adversely effect the domestic investment programs of U.S. firms, and, as such, impact adversely on the long run structure of capital formation in the economy. To mitigate these problems the committee amendment provides that investment and foreign tax credits which would otherwise expire in 1976 (e.g. investment credits earned before 1970 and foreign tax credits earned in 1971) may be carried forward two additional years. It is the intention of the committee in providing this additional carryforward (for credits that would otherwise expire in 1976) to make it possible to use these credits against income generated in these two additional years. In addition, this will provide time in the next two years to see whether any other relief needs to be provided in these cases.

Explanation of provision

The committee amendment provides that investment and foreign tax credits that may be carried over to 1976, but which would otherwise expire after this year may be carried over for two additional years, to 1977 and 1978. This additional carryforward in the case of the investment credit does not apply to credits that might expire in 1977 or 1978, but only to credits which would expire in 1976. Similarly, the additional carryforward in the case of the foreign tax credit does not apply to credits expiring in 1977 or 1978.

The House bill contains no comparable provision.

Effective date

This provision is effective for foreign tax or investment credits which would otherwise expire after being carried forward to tax years ending in 1976.

[1] However, pre-1971 investment credits are allowed a 10-year carryover.

Revenue effects

It is estimated that this provision will result in a decrease in budget receipts of $14 million in fiscal year 1977 and $30 million in fiscal year 1978.

4. Additional 2-percent Investment Credit for employee stock ownership plans (ESOPs) and certain other changes (sec. 804 of the bill, secs. 46, 401, 415, and 1504 of the Code, and sec. 301(d) of The Tax Reduction Act of 1975

Present law

Under present law, employee compensation paid in the form of employer contributions under an employee stock ownership plan (ESOP) is treated as deferred compensation for tax purposes. that is, the employee generally is not taxed on these employer contributions until they are distributed under the plan.

ESOPs are generally designed to be tax-qualified plans. In order to qualify, a plan must, for example, satisfy rules prohibiting discrimination in favor of highly paid employees, and it must meet standards relating to employee participation, vesting, benefit and contribution levels, the form of the benefits, and the security of the benefits. Although, in limited circumstances a contribution to a plan can be withdrawn by the employer if it is made by mistake, the tax law does not permit withdrawal of a contribution merely because it is not deductible. Under the tax law, if a plan meets these requirements, in addition to deferral of employee tax on employer contributions the employer is allowed a deduction (within limitations) for his contributions, the income earned on assets held under the plan is generally not taxed until it is distributed, special 10-year income averaging rules apply to distributions made in a lump sum, and estate and gift tax exclusions are provided.

An ESOP uses a tax-qualified stock bonus plan[1] or a combination of a qualified stock bonus plan and a qualified stock money pension plan.[2] It is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay on their part, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees.

Under an ESOP, an employee stock ownership trust generally acquires stock of the employer with the proceeds of a loan made to it by a financial institution. Typically, the loan is guaranteed by the employer. The employer's contributions to the employee trust are applied to retire the loan so that, as the loan is retired. and as the value of the employer stock increases, the beneficial interest of the employees increases. Of course, if the employer fails to make the required contributions, or if the value of the employer's stock declines, the beneficial interest of the employees declines.

[1] A qualified stock bonus plan is required to distribute benefits in the form of employer stock.

[2] A pension plan which invests in employer securities. and under which employer contributions are credited to the separate accounts of employees. An employee's benefits under such a plan are based upon the balance of his account.

Under present tax law, an employer is entitled to an additional percentage point of the investment tax credit[3] (11 percent rather than 10 percent) if it contributes the additional credit to an employee trust which satisfies the requirements of the Tax Reduction Act of 1975. The ESOP, which may be a qualified or nonqualified plan, must satisfy special rules as to vesting,[4] employee participation,[5] allocation of employer contributions,[6] benefit and contribution limits,[7] and voting of stock held by a trust under the plan.[8] The vesting, allocation, and voting rules are generally considered more favorable to rank and file employees than those which are required for tax qualification.

Reasons for change

Several problems have arisen under the investment tax credit rules designed to encourage the adoption of ESOPs. For example, because the additional investment tax credit is only available for a short period, many employers have not become aware of it in time to establish an ESOP. This lag in recognition of the new provisions and uncertainty as to how they would be applied probably accounts for the modest number of ESOPs established under the investment tax credit rules.[9] Also, because of the short period during which investments may qualify for the additional credit, some employers have found that the cost of establishing an ESOP under the investment tax credit rules is unreasonably high in relation to the benefits of the plan.

The investment tax credit recapture and redetermination rules are another factor which has discouraged the adoption of ESOPs. Under those rules, if a portion of the additional investment tax credit is recaptured or the credit is redetermined by the Internal Revenue Service to be a smaller amount than claimed, the employer must bear the cost of repaying the excess credit; he cannot recover it from the employee trust under an ESOP.

Special problems have discouraged the adoption of ESOPs by regulated utilities. Publicly regulated utilities have been reluctant to establish ESOP's under the investment tax credit rules because they are concerned that regulatory commissions will require that the additional investment tax credit be "flowed-through" to customers. If the regulatory commissions take that position, the utilities will be required, in effect, to pay out the additional investment tax credit twice—once to the ESOP and then again to the customers.

Explanation of provisions

Under the committee amendment, an employer is entitled to two additional percentage points of investment tax credit (12 percent

[3] The additional credit is allowed with respect to qualifying investments made after January 21, 1975, and before January 1, 1977.

[4] Each participant's right to stock allocated to his account under these rules must be nonforfeitable.

[5] The ESOP must satisfy the same participation rules applicable to qualified plans.

[6] An employee who participates in the plan at any time during the year for which an employer contribution is made is entitled to a share of the employer contribution, based upon the amount of compensation paid to him by the employer. Only the first $100,000 of employee compensation is considered for purposes of the plan.

[7] The ESOP is subject to the same benefit and contribution limitations applicable to qualified plans.

[8] Employees must be entitled to direct the voting of employer stock allocated to their accounts under the employee trust. The plan need not permit employees to direct the voting of unallocated employee stock held by the trust.

[9] As of March 31, 1976, 22 applications were pending in the IRS for determination letters with respect to ESOPs under the investment credit rules. As of that date, three favorable determination letters were issued under those rules and two cases were closed without the issuance of a letter.

rather than 10 percent) if he contributes employer securities equal in value to the additional credit to an ESOP which satisfies the Tax Reduction Act of 1975. Consequently, the ESOP is funded by a reduction of the employer's tax liability.

The committee amendment also makes a number of technical modifications in the investment tax credit ESOP provisions of the Internal Revenue Code and the Tax Reduction Act of 1975. These modifications, discussed below, are designed to overcome problems faced by companies which wanted to establish employee stock ownership plans under that Act. The House bill did not provide an additional investment tax credit in these cases or deal with the technical modifications.

Flow-through of investment tax credit.—Because the entire additional investment tax credit is intended to go to the employees participating in an ESOP, the entire investment credit is not to be available to a company if a public service commission requires a utility to flow through any part of that additional credit through to the consumer.

Recapture and redetermination of tax credit.—Where an investment credit is subject to recapture or a company's income or investment is redetermined with the result that the investment tax credit should be decreased, under the committee amendment, the amount of decrease can be applied to offset employer contributions for other years.

Time of contribution

Under the committee amendment, where the full amount of investment tax credit is not allowed for a year because the credit is limited on the basis of the tax for the year, the additional credit can be contributed to the plan as it is allowed. Also, it is the committee's intention that if the investment credit is carried back from the year of investment in qualifying property to a prior year, the additional investment credit which is allowed as a result of the carryback is to be contributed to the ESOP for the year of the investment and is to be allocated to plan participants in the same manner as if it had been allowed in the year of investment.

Administrative expenses.—Limited amounts of administrative expenses for establishing an ESOP can be charged to an investment tax credit ESOP under the committee amendment. The maximum amount which may be charged is 10 percent of the first $100,000 of the amount required to be transferred to the ESOP for the taxable year in which the plan is established, and 5 percent of any additional amount for such year. In addition, on-going costs of administration (up to 10 percent of the first $100,000 of the trust's dividend income plus 5 percent of the remaining dividend income) could also be charged to an ESOP.

Employee participation.—Generally, under the committee amendment an investiment tax credit ESOP must cover all employees who want to participate, except that employees with less than 3 years of service or under age 25 may be excluded.

Definition of employer securities.—In order to extend the benefits of employee stock ownership to "brother-sister" corporations and "second-tier" parent-subsidiary groups, the committee amendment permits the stock of a member of a controlled group of corporations to be used as employer securities for another member of the group. This rule also permits the stock of a parent corporation to be used as employer security with respect to a subsidiary where the parent owns

80 percent or more of the subsidiary's voting stock but does not own at least 80 percent of the subsidiary's nonvoting stock which is limited and preferred as to dividends. In this situation, the subsidiary's stock could also be used as employer securities.

Consolidated returns.—The rules for determining whether there is a sufficient affiliation between corporations to permit the filing of a consolidated return would be applied without regard to employer securities held by an ESOP.

Compensation.—Under the committee amendment, a participant's compensation is defined to be the same as under rules of the Code which limit contributions to qualified plans.

Fiduciary matters and plan participation.—The committee amendment makes clear that an ESOP is not to be disqualified under any rule of the tax law because it acquires or holds employer securities under the investment tax credit rules. Thus, an ESOP could acquire and hold employer securities without being required to satisfy a requirement that the plan be for the "exclusive benefit" of employees. Additionally, because it is anticipated that ESOPs may borrow in order to acquire employer securities in addition to those required to be transferred to the plan, the committee amendment clarifies present law by providing that a fiduciary of an investment tax credit ESOP can make loans to the plan.

Generally, under the committee amendment an investment tax credit ESOP must cover all employees who want to participate, except that employees with less than 3 years of service or under age 25 may be excluded. Under the committee amendment, if an employee is represented by a union which does not elect to have its members participate under an ESOP, the individual employees could nevertheless elect to participate in the plan. Additionally, ESOPs would not be considered employee benefit plans, employee pension plans, or employee welfare plans under Federal law (except tax law).

Permanent plan.—The committee amendment also makes clear that an ESOP which satisfies the investment tax credit rules does not fail to be a permanent program merely because employer contributions are not made for a year if the additional investment tax credit is not available for the year (for reasons other than the employer's failure to make the contribution).

Grace period.—A grace period is provided by the committee amendment in order to allow employers who wished to establish investment credit ESOPs under the Tax Reduction Act of 1975 to take advantage of the other changes made by committee amendment. If, before the expiration of 90 days after the enactment of this bill, an employer establishes a written plan which meets the requirements of the Tax Reduction Act and, before the end of the 90-day period, transfers to the plan the amount it would have been required to transfer to the plan in order to claim the additional 1-percent investment tax credit for its taxable year which includes August 1, 1975, the employer may claim the credit for that taxable year.

Other provisions.—In situations where the value of employer stock can be expected to increase rapidly, the rule of present law limiting the annual addition to the account of a participant in a defined contribution plan to $25,000 (plus a cost-of-living adjustment) may discourage the establishment of an ESOP designed to acquire employer stock from a present shareholder by causing the shareholder to suffer an unacceptable level of dilution of his interest in the company. In order to remove this barrier to ESOPs, the committee amendment doubles the dollar limitation provided by present law in the case of defined contribution plans but the additional amount may only consist of employer stock. Also, under the committee amendment, the limitation on benefits which may be provided under a defined benefit plan would be reduced where the additional defined contribution limitation is allowed for an ESOP. In order to assure that the doubled allowance is not available to a plan unless rank-and-file employees are the chief beneficiaries of the plan, however, under the amendment, the doubled allowance is not available for a plan if more than one-third of the employer contributions to the plan for a year are allocated to employees who are officers or shareholders, or whose compensation for the year exceeds twice the amount of the dollar limitation ordinarily applicable to the annual addition to the account of a participant in a defined contribution plan. (This is not intended to affect any determination of which employees are considered highly compensated for purposes of the coverage and nondiscrimination requirements applicable to qualified plans generally.) For this purpose, employees who hold 10 percent or less (determined with attribution rules) of the employer's stock (outside of the ESOP) are not considered shareholders.

Effective dates

The additional 2 percentage points of investment credit available in connection with an ESOP is to become available after December 31, 1976.

The rule relating to the time the additional credit is to be contributed to an ESOP is effective for taxable years beginning after December 31, 1976.

The provision relating to administrative expenses and costs of establishing an ESOP apply for taxable years beginning after December 31, 1975, and the rules concerning contribution limitations apply for years beginning after December 31, 1975. The rules applicable to employee participation in ESOPs apply for taxable years beginning after December 31, 1975 if the employer makes a plan contribution after the date of the enactment of the Act. The new investment tax credit recapture and redetermination rules, the plan permanency rule, the consolidated return rule, the rule allowing loans by a fiduciary, the employee compensation rule, the employer securities rule, and the rule dealing with the treatment of ESOPs under Federal law would apply for taxable years beginning after December 31, 1974.

The rules of the committee amendment requiring broader coverage of employees under investment tax credit ESOPs would apply to plans to which a contribution is made after the date of the enactment of the Act. The rules regarding the definition of employer securities and consolidated returns would apply for years beginning after December 31, 1975.

The committee concluded that it was desirable to provide that these rules for administrative expenses, investment tax credit redetermination, the acquisition and holding of employers stocks as well as rules regarding compensation taken into account, borrowing from a plan fiduciary, and the relationship of plan contributions to the amount of allowable additional credit, to apply for the past as well as the future. Accordingly, the committee amendment applies these rules as of March 29, 1975, the effective date of the investment tax credit ESOP provisions of that Act.

The rule preventing flow-through of the additional investment tax credit applied 90 days after the enactment of the Act.

Revenue effect

It is estimated that the additional 2-percent investment credit for ESOPs will reduce tax liability by $235 million for fiscal year 1977, $584 million for fiscal year 1978, and $917 million for fiscal year 1981.

5. Investment Credit in the Case of Movies and Television Films (sec. 805 of the bill and sec. 48 of the Code)

Present law

Under present law, taxpayers are entitled to receive an investment credit for tangible personal property (i.e., section 38 property) which is placed in service by the taxpayer. In order to receive the full credit, the property placed in service by the taxpayer must have a useful life of at least 7 years. If the property has a useful life of at least 5 years (but less than 7 years) the taxpayer is entitled to two-thirds of the full credit. If the property has a useful life of at least 3 years (but less than 5 years) the taxpayer is entitled to a one-third credit. In addition, there cannot be any predominant foreign use of the property during any taxable year, or the property will cease to qualify as section 38 property.

Prior to 1971, it was not clear whether (and if so, under what conditions) the investment credit was available for movie or television films. However, a court case had held that movie films were tangible personal property eligible for the investment credit. During the legislative consideration of the Revenue Act of 1971, it was made clear that motion pictures and television films are to be treated as tangible personal property which is eligible for the investment credit (i.e., section 38 property). However, this issue is still being litigated for years prior to 1971, and there are still a number of unsettled issues, such as how to determine the useful life of a film, the basis on which the credit is to be computed, and how to determine whether there has been a predominant foreign use of the film.

Reasons for change

Due to the uncertainties of present law with respect to the questions of useful life and predominant foreign use, it is often difficult to determine whether a film is entitled to a full credit, a partial one-third or two-thirds credit, or possibly to no credit. It is desirable to clear up these issues, in order to avoid costly litigation with respect to the past, and to allow accurate investment planning for the movie industry in future years.

To achieve the objective set out above, the committee amendment, for past years, allows taxpayers to determine their investment credit on a film-by-film basis in accordance with certain statutory rules prescribed under the bill with respect to useful life and predominant foreign use, or to elect to take a 40-percent compromise credit for all their films, regardless of the actual useful life or foreign use of any particular film. The committee believes that this 40-percent figure represents a fair compromise between the litigating position of the Internal Revenue Service, on the one hand, and members of the industry, on the other hand. This is substantially the same as is provided by the House bill.

In addition, since the major purpose of the investment credit is to create jobs in the United States, the committee amendment provides that for the future the amount of the investment credit in the case of movie films is to depend on the place of production of the film (i.e., United States or foreign), rather than on the place where revenues are received for showing the film. Thus, the foreign use test will not apply to movie films for the future. As a further incentive to encourage U.S. production of films, the committee amendment provides that where 80 percent or more of the direct production costs of the film are U.S. costs, the credit base for the film is to include certain indirect costs (such as general overhead costs, the cost of screen rights, etc.), but otherwise the credit base will be limited to direct U.S. production costs.

As to the issue of useful life, taxpayers many take a two-thirds credit on all their films (regardless of the useful life of particular films), or they may elect to determine useful life on a film-by-film basis. Under this method of computing the credit, the useful life of the film will be treated as having ended when 90 percent of the basis of the film has been recovered through depreciation. Except as noted otherwise below, this is substantially the same as is provided by the House bill.

Explanation of provisions

As outlined above, the committee amendment provides somewhat different rules in this area with respect to the past than it does for the future, because the rules for the past are intended to compromise the litigating positions of the Internal Revenue Service and members of the film industry, based on transactions which have already occurred. Also, the rules are different for the future because the emphasis for the future is to be on providing jobs in the United States.

Films placed in service in future years

General rule.—For the future, as a general rule, under the committee amendment, taxpayers are to receive two-thirds of a full credit for all their films regardless of the actual useful life (or foreign use) of any particular film. This rule will apply to all films placed in service (i.e., initially released for public exhibition in any medium) in taxable years beginning after December 31, 1974, regardleses of whether any particular film had a useful life of 7 years or more (so that it would be entitled to a full credit if judged on an individual basis), or less than 3 years (so that it would not be entitled to any credit if judged separately). The credit is to be available only for "qualified films", i.e., motion picture films or television films or tapes created primarily for use as public entertainment, and educational films, i.e., generally films used in primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries and government agencies (thus for example, excluding industrial training films).[1] Also, the credit would be available for TV pilot films and dramatic or comedy series, such as "Mod Squad" or "The

[1] The inclusion of educational films is a change in the House bill made by the committee amendment.

Mary Tyler Moore Show." However, the credit would not be available for films which were topical or transitory in nature, such as news shows, interview shows such as "Johnny Carson" or "Firing Line", or films or tapes of sports events, even though some of these shows might be shown in subsequent years, Also, the credit would not be available for used films (i.e., films shown previously in any market).

The 90-percent method.—Under the committee amendment, as an alternative to the general rule, taxpayers may elect to have the investment credit determined for all of their qualified films placed in service in the future on a film-by-film basis. Thus, if a particular film had a useful life of 7 years or more, the taxpayer would be entitled to a full credit for that film. On the other hand, if a film had a useful life of less than 3 years the taxpayer would not be entitled to any credit for that film. For purposes of these rules the film's useful life is to be treated as ending at the close of the year by the end of which the aggregate allowable deductions for depreciation equal at least 90 percent of the basis of the film (adjusted for any partial dipositions, but determined without regard to any other adjustments).

For example, assume that a taxpayer who is on a calendar year basis releases (i.e., places in service) a film with a basis of $100 on February 1, 1975. The film is depreciated under the income forecast method and $50 of depreciation is allowable with respect to this film for 1975, $30 for 1976 and $10 is for 1977. Thus, $90 of depreciation is allowable by the close of 1977, and since this represents 90 percent of the basis of the film the useful life of the film is to be treated as having ended on December 31, 1977, or less than three years after the film was placed in service; therefore, no credit would be available with respect to this film, and any credit or partial credit which had been claimed would be subject to recapture.

On the other hand, if less than $90 of basis had been recovered by the close of 1977, the film would be eligible for at least a partial credit.[2]

Of course, films of a transitory or topical nature would not be eligible for the investment credit, no matter when their basis was recovered through depreciation.

If the actual useful life of a film is less than its anticipated useful life in the case of a taxpayer using the 90-percent method, the credit is to be subject to recapture under essentially the same rules which apply in the case of any other section 38 property where the actual useful life proves to be shorter than the anticipated life. Also, in the case of a disposition or partial disposition of rights in the film before the end of the anticipated useful life of the film, there would be a full or partial recapture.[3]

A partial disposition includes the sale of commercial exploitation rights in any medium (television, for example) or in any geographic area (such as Great Britain, or any other foreign country). On the other hand, an ordinary commercial license for less than the

[2] For purposes of these calculations, salvage value would not be taken into account; thus, if a film has a basis of $100, and a salvage value of $10, the useful life would not end until $90 of depreciation was recoverable (i.e., 90 percent of the $100 basis, not 90 percent of the $100 basis minus the $10 salvage value, which would equal $81).

[3] This rule is not to apply to a taxpayer using the general rule (the two-thirds method), however, since the amount of the credit under this method does not depend on the useful life of any particular film.

full rights of exploitation in a particular medium or area generally does not constitute a disposition or partial disposition for purposes of these rules.

Also, a sale of exploitation rights to a member of an "affiliated group" does not constitute a partial disposition. For example, U.S. film distributors commonly exploit the foreign rights to a U.S.-made film through use of a foreign affiliate. For purposes of these rules, the term "affiliated group" is to have the same meaning as it does for purposes of section 1504, but with a 50-percent control test (instead of 80 percent), and with no exclusion of corporations (such as foreign affiliates) described in section 1504(b). Also where stock in a foreign film distributor is held by the trust of a pension plan which benefits the employees of that foreign distributor, any U.S. corporation holding stock in the foreign distributor may add the stock held by the pension trust to its own stock holdings for purposes of determining if the foreign film distributor is an "affiliate" of the U.S. corporation. For example, if two American distributors each hold 49 percent of the stock in a foreign distributor, and the pension trust of the foreign distributor holds the remaining 2 percent, the foreign distributor would be an affiliate of both of the American corporations (because each would add the 2 percent interest held by the pension trust to its own 49 percent interest).

Some of the principles above may be illustrated as follows. A film distributor having a 100 percent ownership interest in a television dramatic series, consisting of 24 weekly episodes, elects to use the 90 percent method of determining its investment credit for movie films. The distributor estimates the useful life of the series will be 7 years or more and claims a full credit. The distributor licenses a United States television network; under the agreement the network acquires first-run U.S. television rights for $100, with the right to repeat each episode over the network one time for an additional fee of $25.

In the following year,[4] the American distributor sells the exclusive rights to exhibit the series in Great Britain to a British corporation which is not affiliated with the American distributor. This constitutes a partial disposition of the series which triggers a partial rerecapture of the credit.

If, on the other hand, the American distributor entered into a limited licensing agreement with the foreign corporation (similar to the agreement which it had entered with the American network), or sold the British rights to the series to a member of an affiliated group, there would be no partial disposition, and consequently, no recapture.

Films placed in service for taxable years beginning after December 31, 1974, are not subject to the foreign use rule. This is because, in the case of a movie film, jobs are created where the film is produced, not where it is shown. To use the 90-percent method, the taxpayer would have to make an election, in a time and manner to be prescribed in regulations.

Once the taxpayer (or any related business entity) has operated under the general rule for the future, or has elected to use the 90-percent method, he cannot change his method of operation without the consent of the Internal Revenue Service. The committee intends that

[4] Where a TV series is involved, each weekly segment is placed in service when it is first shown. Thus, the various segments of the series will not necessarily be placed in service in the same year.

permission will be granted where the taxpayer undergoes a substantial transformation in its operations, but generally will not be granted otherwise. For example, it might be appropriate to grant permission if a film studio using the 90-percent method merged with a studio using the two-thirds method; or in cases where a studio shifted from the production of short-lived grade B westerns to long-lived classic films.

For purposes of these rules, related business entities include all component members of a controlled group of corporations (within the meaning of section 1563(a), without regard to subsection 1563(b) (2)) but subject to a 50-percent control test. Also classified as "related business entities" are any corporations, partnerships, trusts, estates, proprietorships, or other entities, if "related persons", each of whom have at least a 10-percent interest in each entity, also have, in the aggregate, at least 50 percent of the beneficial interests in those entities.[5]

Thus, for example, if individuals A, B, C, and D each have a 25-percent interest in studio 1, which uses the two-thirds method in 1975, studio 2, formed in 1976, with A and B each having a 50-percent profits interest, cannot elect the 90-percent method for 1976 without the permission of the Internal Revenue Service, Studio 1 and studio 2 are related, because A and B each have at least a 10-percent interest in both studios and together A and B have at least 50 percent of the beneficial interest of both studios. Since studio 1 used the two-thirds method in 1975, studio 2 must have permission to use a different method in 1976.

Credit base.—Since the primary purpose of the investment credit is to create jobs, the committee amendment is designed to encourage the production of films in the United States. Thus, the credit base for motion picture films includes the direct costs which are allocable to production of the film in the United States (including its commonwealths and possessions) and, in addition, if at least 80 percent of the direct production costs are allocable to United States production, the credit base also includes certain indirect "production costs."

Direct production costs include compensation payable to the actors and other production personnel. However, under the committee amendment. certain special rules apply in the case of participations (described below in connection with indirect production costs). (The House bill would not allow the investment credit for participations.)

Direct production costs also include expenses for costumes, props, scenery, and similar items, as well as the cost of the film, and the cost of preparing the first distribution of prints (i.e., prints placed in service within 12 months after the film is first released).

Where the film is produced partly in the United States and partly abroad, the direct production costs must be allocated between the U.S. and foreign production of the film. Under the committee amendment, compensation for services is to be allocated to the country where the services are performed. However, compensation paid to United States citizens is to be allocated to the United States, even if the services are performed outside of the United States. Also, payments to a subchap-

[5] The term "beneficial interest" means voting stock in the case of a corporation, profits or capital interest in the case of a partnership, and beneficial interest in the case of a trust or estate. "Related persons" are generally as described in section 267 or 707(b). but for purposes of these rules members of a family consist only of the individual, his spouse, and his minor children.

ter S corporation or to a partnership are to be treated as United States production costs if (and to the extent) that the payments are includable in gross income by a U.S. citizen or any other United States person (which is not a partnership or subchapter S corporation). Amounts paid for equipment and supplies are to be allocated to the country in which the materials are predominantly used (where this can be established for particular materials). Subject to these guidelines, allocation of direct production costs is to be determined under regulations. The committee intends that generally (in the absence of better evidence as to the actual place of predominant use of personnel and materials) direct production costs are to be allocated in accordance with the shooting time of the film.

If 80 percent or more of the direct production costs are allocable to U.S. production, then the credit base for the film is to include all "production costs" of the film (other than the direct foreign production costs, if any). These would include not only the direct production costs, as outlined above, but also certain capitalized costs, including a reasonable allocation of the general overhead of the taxpayer, the cost of obtaining the screen rights to the film, as well as the cost of developing the screenplay, and "residuals" (whether or not capitalized) paid under agreements with labor organizations, such as the Actor's Guild. Generally, residuals are amounts paid under a collective bargaining agreement to all members of the union involved (or in some cases to a guild or union pension, health, or welfare fund). The collective bargaining agreement generally covers all films produced over a period of several years. Residuals may be a percentage of gross receipts from nontheatrical uses of a theatrical film, or a percentage of the minimum salary payable (i.e., scale) to the union member.

Under the committee amendment, participations may be included in the credit base of an 80 percent or more U.S. produced film subject to certain limitations. First, participations may be included in the credit base only to the extent that participations paid to any one person in connection with any one film do not exceed $1 million.[6] Subject to this rule, participations are includible in the investment credit tax base to the extent of the lesser of: (1) 50 percent of participations qualifying under the $1 million limitation, or (2) 25 percent of the production costs of the taxpayer's films for the year (i.e., his investment credit tax base determined without regard to participations or residuals). These limitations are to be applied on a vintage year basis (i.e., participations in films released in the same year are to be considered in the aggregate for purposes of determining whether the 25 percent limitation with respect to those films has been exceeded).

If less than 80 percent of the direct production costs of a film are allocable to U.S. production, then the credit base with respect to that film includes only the direct U.S. production costs.

Some of the principles discussed above may be illustrated as follows. Assume that the total production costs of a film equal $150. Of this amount, $50 are indirect production costs, including $30 for general overhead, $10 for the screen rights and $10 of residuals. The direct

[6] These rules affecting participations apply only for purposes of the investment credit tax base and no inference is intended that similar rules should be applied for other purposes under the tax law (i.e., the taxpayer's basis for depreciation). The committee intends that such questions be determined under the rules of present law.

production costs include $75 of salary and $25 for supplies and materials. Fifty dollars of compensation are paid to United States citizens, and $25 of compensation are paid to non-U.S. actors and production crew, and these individuals perform services both in the U.S. and abroad. Of the $25 used for costume and supplies, $10 are paid for supplies used only in the United States, $5 are paid for costumes used only in a foreign country, and $10 worth of supplies are used both in domestic and foreign shooting. Sixty percent of the shooting time for the film occurs in the U.S., and 40 percent occurs abroad. The calculation is a follows.

U.S. COSTS.		FOREIGN COSTS	
Compensation paid to U.S. citizens	$50		$00
60 pct. of compensation paid to non-U.S. citizens	15	40 pct. of compensation paid to non-U.S. citizens	10
Supplies used only in United States	10	Supplies used only abroad	5
60 pct. of the cost of supplies used in the United States and abroad	6	40 pct. of the cost of supplies used in the United States and abroad	4
Total	81	Total	19

Since 81 percent of the direct cost of production is allocable to United States production, the credit base also includes the $50 of indirect production costs. However, the $10 cost for residuals is not to be eligible for the credit until the year in which these amounts are actually paid.

Of course, under the committee amendment, where a film is purchased before it is placed in service in any medium, the credit base cannot exceed the purchase price of the film (if this is less than the credit base for the film as computed under the rules outlined above). Also, in the case of the transfer of a film to a lessee (under section 48(d) of the code), the lessee is generally to be treated as having acquired the film for an amount equal to the lessor's credit base with respect to that film (rather than its fair market value).

The rules outlined above concerning the credit base apply regardless of whether the taxpayer uses the general rule (two-thirds method) or the 90 percent method.

Who is entitled to the credit.—Under the committee amendment, a taxpayer is to be entitled to the investment credit for a movie film if, and to the extent, that he has an "ownership interest" in the film at the time it is placed in service. For purposes of these rules, a taxpayer will be treated as having an ownership interest to the extent that his captial is at risk.

Thus, if the expenses of producing a movie are incurred by the producer, but are reimbursed by the distributor, either by means of a nonrecourse loan or otherwise, the distributor would be entitled to the credit, because the distributor's capital is at risk. Also, if the production costs are paid from the proceeds of a nonrecourse loan supplied by a bank but guaranteed by the distributor, then the distributor would be entitled to the credit because its capital was at risk in connection with the film. A similar result would follow if the producer was liable to the bank on the loan, but the distributor had contracted to pay at least the amount of the loan to the producer in connection with the film.

The determination as to whose capital is at risk in connection with the film (and, therefore, as to who is entitled to the credit) is to be made as of the time the film is first placed in service (*i.e.*, released). Thereafter, the film would be considered used property, which is not to be eligible for the credit under the committee bill.

Generally, where the distributor has borne the cost of producing a film, and first releases it through the medium of movie houses, it is the distributor who is entitled to the credit. In the case of a film or series which is made for television, the producer-distributor will also generally be entitled to the credit where the film is exhibited over the network pursuant to a licensing agreement. On the other hand, if the network purchased all rights to the film or series before it was placed in service, the network would be entitled to the credit.

It is possible that more than one taxpayer may be entitled to a share of the credit for the same film as, for example, where several investors put up a portion of the capital needed to produce the film pursuant to a joint venture agreement. Generally, where more than one party bears the risk of loss with respect to a particular film, the Secretary of the Treasury or his delegate may establish procedures for determining who is entitled to the credit, or partial credit. (Of course, where there are several parties to a transaction involving a movie film, and one party is entitled to the investment credit with respect to that film under these rules, whereas the other party is not, the committee anticipates that the availability of the investment credit may often be taken into account by the parties in determining their contract arrangements.)

It is also possible that more than one taxpayer may be entitled to the credit for a particular film where the film is placed in service in more than one medium or more than one geographic area. For example, suppose that a producer creates a U.S. produced film having a credit base of $100. A distributor acquires exclusive perpetual distribution rights within the United States in exchange for a lump-sum payment of $50 and the film is subsequently placed in service. The distributor is entitled to a credit with respect to the film based on his cost of $50 in acquiring the U.S. rights. The producer, who retains the other rights to the film, would also be entitled to a part of the credit based on his capital at risk. The producer's credit base would be computed by subtracting the cost borne by the U.S. distributor ($50) from the credit base which the producer would otherwise be entitled to (i.e., the $100 cost of production). Thus, the producer's credit base would equal $50 in this case.

Films Placed in Service in the Past

For the past (*i.e.*, for taxable years beginning before January 1, 1975), in general, taxpayers will come under one of two rules, either the "90-percent method," as described above, with certain modifications to deal with the foreign-use problem, or a "40-percent method," under which a taxpayer would be entitled to receive 40 percent of a full credit for all of his films, regardless of the useful life or predominant foreign use of any particular film. However, taxpayers may elect to come under the general rule for the future (the two-thirds method, as described above) for all section 50 property placed in service after the restoration of the investment credit under the Revenue Act of 1971.

Finally, certain taxpayers, who have already filed suit for a determination as to their entitlement to the investment credit for past years, elect the application of the rules of present law, rather than the provisions of this Act, in determining their entitlement to the credit for all past periods.

General rule for past.—Under the committee amendment, as a general rule, the investment credit for films placed in service in taxable years beginning before January 1, 1975, is to be computed on a film-by-film basis. In determining the useful life of the film, taxpayers would use the 90-percent method as described above. However, an additional rule is necessary for the past to determine whether or not there was predominant foreign use of the film.

Under the committee amendment, a film is to be treated as having a predominant foreign use in the first taxable year in which 50 percent or more of the gross revenues received or accrued from the film were received or accrued from showing the film outside the United States. This is a year-by-year test (not a cumulative test). For example, assume a film was released on February 1, 1972, and revenues of $100 were received that year from showing the film in the United States (with no foreign revenues), while in 1973 there were $75 of income from U.S. showings, and $25 of income from foreign exhibitions, and in 1974 there were $40 of U.S. revenues, and $60 of revenue from foreign exhibitions. In this case, there would be a predominant foreign use of the film in 1974, and as a result the film would cease to qualify as section 38 property in that year. This would mean that the taxpayer would not be entitled to an investment credit with respect to the film because the disqualifying event would have occurred less than 3 years after the property had been placed in service.[7]

Films of a transitory or topical nature would not be eligible for an investment credit.[8]

The 40-percent method.—Under the committee amendment the taxpayer can elect to receive 40 percent of a full credit for all of his films placed in service in taxable years beginning before January 1, 1975.[9] If the taxpayer makes this election, he is to receive the 40-percent credit, regardless of the actual useful life or predominant foreign use of any particular film. This 40-percent method is offered as a way of avoiding costly litigation with respect to past years. It is believed that this method achieves, for the average member of the film industry, about the same size credit which he would receive for all his films, on the average, were he actually to litigate.

A taxpayer is not to receive a credit for any films of a transitory or topical nature (because almost all of these films have a useful life of less than three years). Also, a taxpayer using the 40-percent method

[7] For this limited purpose, gross foreign revenues from showing films in future years must also be taken into account. In other words, if a taxpayer uses the 90-percent method for 1974, and 50 percent or more of the revenues from showing the film in 1975 are from foreign exhibitions, this would constitute a predominant foreign use of the film placed in service in 1974, and the taxpayer would not be entitled to an investment credit with respect to that film.

[8] The committee intends that no influence should be drawn from this report or this legislation as to what constitutes useful life, predominant foreign use, the basis on which the credit is to be computed or any other aspect of the application of the investment credit under present law.

[9] As described below, the taxpayer can also use this method for films placed in service on or before August 15, 1971, but elect to use the general rule for the future for all of his section 50 films.

for the past is not entitled to credits for any films which were produced and shown exclusively abroad.

The election to use the 40-percent method is to be made by the taxpayer within six months after the date of enactment of this bill in a manner to be prescribed in regulations. Any such election, once made, is to apply to all of the taxpayer's films placed in service in the past (except those, if any, covered under the general rule for the future), and can be revoked only with the consent of the Internal Revenue Service.

To prevent a situation where two different taxpayers may attempt to claim the credit for the same film, the committee bill provides that any taxpayer making the 40-percent election must consent to join in a judicial proceeding to determine which of the competing claimants was entitled to the credit, or whether each of the parties was entitled to part of the credit.[10] The rules with respect to entitlement to the credit (i.e., the capital at risk rules, etc.) are the same for the past as for the future.

Credit base.—In general, under the committee amendment, the rules as to the size of the credit base for the past (including those with respect to participations) are similar to the rules which are to apply for the future. However, for the past there has not been a U.S. production test in connection with movie films, and the committee does not believe it would be appropriate to impose such a test retroactively. (Although the committee amendment does impose a U.S. production test for the future, in order to encourage the U.S. production of movie films.) Thus, for the past, taxpayers may include in the credit base all the direct and indirect expenses of production, as described above, regardless of whether the film would have satisfied the 80-percent United States direct production expenses test and regardless of whether some of the expenses (actors' pay, costumes, etc.) included in the credit base were paid for services performed abroad, or for equipment and supplies which were used abroad.

The rules described above with respect to the credit base would apply both to taxpayers using the 90-percent method for the past, and to taxpayers using the 40-percent method.

Application of the general rule for the future to certain past years.—In connection with the Revenue Act of 1971 Congress made clear that it intended the investment credit to be available for movie films (whereas this question had not been completely resolved prior to that time) even though, as described above, certain subsidiary issues were not settled in that Act. For this reason, the committee amendment provides that those taxpayers who wish to do so are to be allowed to use the general rule for the future with respect to all of their section 50 property (generally property placed in service after August 15, 1971). Thus, the committee amendment provides that taxpayers may elect to use the general rule for the future for all of their section 50 movie films. (Taxpayers making this election

[10] The committee is concerned, however, that this procedure should not unnecessarily delay the allowance of the credit in cases where it is reasonably clear that there is only one plausible person who has a right to claim the credit. The committee intends that the Service will develop such reporting and other procedures as it deems necessary to determine whether there is a likelihood that several persons may claim a credit with respect to the same film, and that where there is no such likelihood, allowance of the credit will not be unduly delayed.

could still use either the 90-percent method or the 40-percent method for all films placed in service in the past which do not qualify as section 50 property.)

Taxpayers who make this election are to be covered under the general rule for the future for all purposes, including, for example, the rules with respect to the size of the credit base, which include an 80 percent U.S. production test and exclude expenses of foreign production from the credit base.

The election to use the general rule for the future for section 50 films would have to be made within one year after the date of enactment of the bill, in a manner to be prescribed in regulations. The election would have to apply to all of the taxpayer's section 50 films, and the election, once made, could not be revoked without the consent of the Internal Revenue Service. Other rules with respect to use of this method for the past may also be prescribed by regulations.

Taxpayers who have already litigated

Some taxpayers have already litigated the issues outlined above for certain prior years. The committee believes that these taxpayers should be entitled to the fruits of their litigation because of the substantial effort and expense which they have incurred in connection with their suits. Accordingly, the committee amendment provides that any taxpayer who has filed a petition before any court before January 1, 1976, with respect to his entitlement to the investment credit for any prior year, may elect (within 30 days after the date of enactment) to have his right to the investment credit for all years beginning prior to January 1, 1975, determined under present law, as interpreted by the courts, rather than under one of the methods prescribed in this bill. (As an alternative, taxpayers who have filed suit prior to January 1, 1976, may elect to have their credit determined under present law for years prior to 1971, and elect the general rule for the future for all their section 50 property.) But, of course, issues which have not already been resolved by court proceedings (such as predominant foreign use, the size of the credit base, etc.) must be settled by further litigation, and it is intended that no inference be drawn from the provisions of this bill as to how such issues should be resolved under present law.

Generally, under this procedure, a taxpayer wishing to make an election under these provisions may do so by mailing a letter to this effect to the Commissioner of Internal Revenue within the 30-day period. Any such election is to be irrevocable.

Taxpayers relying on litigation to determine their credits for past years still must use either the general rule for the future or the 90-percent method for all taxable years beginning after December 31, 1974.

Differences between the committee amendment and the House bill.—As indicated previously, the provisions of the committee amendment are similar to the provisions under the House bill in most respects. However, the committee amendment makes clear that the investment credit is to be available to educational films, as well as entertainment films. Also, the House bill imposes a restriction on investment credit carryovers in the case of taxpayers electing the 40 percent method only for years prior to 1971; the committee amendment permits such carryovers to be governed under the usual rules. Also, the committee amendment permits participations to be included in the credit base, subject to certain limitations, whereas the House bill excluded participations from the credit base altogether. The committee amendment also permits any taxpayer who had filed a petition in a court by January 1, 1976, to have his investment credit for prior years determined under present law (as interpreted by the courts) rather than accepting the compromise settlement provided in the committee amendment; under the House bill, only taxpayers who had received a final judgment were permitted to elect out.

Effective dates

The effective dates of these provisions have been described above. In general, the rules with respect to the general rule for the future and the 90-percent method apply to films placed in service in taxable years beginning after December 31, 1974. In general, taxpayers may use either the 90-percent or the 40-percent method for all prior years, but may alternatively elect to use the general rule for the future for all section 50 property.

Revenue effect

It is estimated that the provisions of this section will result in a revenue cost of $54 million in the fiscal year 1977 and a loss of $5 million a year thereafter.

6. Investment Credit in the Case of Vessels Constructed From Funds Withdrawn From the Capital Construction Fund. (sec. 806 of the bill and sec. 46(g) of the Code)

Present law

Present law provides that income tax is not to be payable on certain income from domestic shipping set aside in a capital construction fund. However, when monies are withdrawn from this fund, they then are generally taxable unless they are used for the construction of ships to be used primarily in domestic trade. The purpose of this treatment generally is to provide a tax inducement to aid in the building of a domestic merchant fleet. To prevent a double allowance for these tax-deferred amounts, present law provides that when these funds are used to finance ship construction there is to be no tax cost, or basis. This means that no depreciation is permitted on the part of the investment in the ship that is financed out of the capital construction fund. Under present law, the amount of the investment credit available is also based on the tax cost or basis of a qualifying property (sec. 46(c)(1)(A) of the code). As a result, the Internal Revenue Service has ruled that no investment credit is available in the case of vessels built, purchased, or reconstructed with monies withdrawn from the capital construction fund.

Reasons for change

The Merchant Marine Act was amended and the tax treatment accorded domestic shipping almost completely revised when the investment credit was not in effect (1970). As a result, the Congress did not at that time address itself to the question of whether the investment tax credit should be available in the case of a vessel constructed with funds withdrawn from the tax-deferred capital construction fund. In addition, since the tax provisions relating to the capital construction fund are in the Merchant Marine Act of 1936 rather than in the Internal Revenue Code, this question was not reviewed when the investment credit was subsequently generally restored.

The committee has studied this problem and believes that the effect of denying the investment credit in the case of ships built from monies taken from tax-deferred construction funds has the effect of substantially reducing the inducement to set funds aside in construction funds rather than using them for other forms of capital formation for which an investment credit is available. It is the committee's understanding that, in fact, the funds set aside for this purpose since the restoration of the investment credit generally have been much more limited than was previously estimated. The committee believes that it is a matter of national concern that the U.S. shipping industry have a modern fleet and that it be competitive in world markets. This is necessary from the standpoint of our international trading position as well as from the standpoint of having a fleet in being upon which the United States can call in times of international crisis. As a result the committee concluded that it was undesirable to reduce the incentive effect of the tax deferred construction fund by denying the investment credit in the case of monies withdrawn from this fund for ship construction while the investment credit is available for many other forms of capital investment.

Explanation of provision

The committee amendment (sec. 46(g) of the code) provides that the amount of a qualified investment for investment credit purposes is not to be reduced because of a deposit in, or qualified withdrawal from, a capital construction fund established under section 21 of the Merchant Marine Act of 1970 or because that provision requires a reduction in basis of property acquired with monies from such a fund. The House bill does not contain any similar provision.

Effective date

The committee amendment is to be effective with respect to investment credits claimed in years beginning after December 31, 1975.

Revenue effect

It is estimated that the amendment will result in a reduction of $21 million in revenues in the fiscal year 1977, $23 million in fiscal year 1978, and $45 million in fiscal year 1981.

7. Net Operating Losses

a. Net Operating Loss Carryover Election (sec. 807 of the bill and sec. 172 of the Code)

Present law

Present law, in general, provides that both individual and corporate taxpayers are allowed to carry a business net operating loss back as a deduction against income for the three taxable years preceding the year in which loss occurred and to carry any remaining unused losses over the five years following the loss year (sec. 172). This general rule enables taxpayers to balance out income and loss over a moving 9-year cycle. Insurance companies, which are generally subject to separate tax rules under subchapter L, are also allowed 3-year carryback and 5-year carryover periods for their losses, either under the section 172 general rule or under separate rules in subchapter L. carryback and five-year carryover rule in the case of certain industries or categories of taxpayers. One exception allows certain regulated transportation corporations to carry back and deduct net operating losses for the usual 3 years and to carry over such losses for 7 years.[1]

A net operating loss is required to be applied against income from other taxable years in the averaging period, beginning with the earliest year in the period. For example, if a business taxpayer, subject to the general 3-year carryback and 5-year carryover rule, has a net operating loss for 1976, the loss is carried first to reduce or eliminate taxable income (if any) reported for 1973, and to the extent any of the loss remains unused, it is then successively applied against any income reported for 1974 and 1975. Any of the 1976 loss unabsorbed by these three carryback years is then used as a deduction on the taxpayer' returns for the succeeding five years, beginning with 1977. Any loss remaining after it has been successively applied in these five years expires and the taxpayer loses the benefit of this unused loss.

Reasons for change

Adverse economic conditions in recent years have caused many business taxpayers to incur sizable net operating losses. In many cases there is some doubt that, because of the severity of the losses and the delay in the economic recovery, these taxpayers will generate sufficient income during their existing carryover periods to enable them to use their large operating loss carryovers. In order to reduce the possibility that this problem will arise in the future, the committee has decided to provide a loss carryover option under which eligible business taxpayers may elect a longer loss carryover in lieu of the loss carryback to which they are otherwise entitled.

Explanation of provision

Under the committee amendment a qualifying business taxpayer with a net operating loss for the taxable year may elect to carry the loss over for a number of additional years equal to the number of years the taxpayer would otherwise be entitled to carry back the loss. For example, a taxpayer subject to the general 3-year carryback and a 5-year carryforward rule may, under the election, carry the loss forward for a total of eight years. These additional carryover years are in lieu of the otherwise available carryback years and a loss under this election may not be carried back to any prior years.

The net operating loss carryover election is available only to those categories of business taxpayers which are presently eligible to carry

[1] Another exception prohibits the carryback of a net operating loss to the extent the net operating loss was attributable to a foreign expropriation loss However, a 10-year carryover period is allowed for the foreign expropriation loss (15 years in the case of a Cuban expropriation loss). A third exception, applicable to financial institutions for taxable years beginning after Deecember 31, 1975, lengthens the carryback period for net operating losses to 10 years and allows the usual 5-year carryover period. Similarly, a bank for cooperatives is presently allowed to carry net operating losses back for 10 years and forward for 5 years. A fourth exception is provided for taxpayers which have incurred net operating losses resulting from increased imports of competing products under trade concessions made pursuant to the Trade Expansion Act of 1962. Where a taxpayer has elected to obtain certification as provided by this Act, it is allowed a 5-year carryback period and the usual 5-year carryover period. Finally, present law also contains a provision designed for American Motors Corporation which permitted a 5-year carryback period and a carryover period of 3 years for losses incurred for taxable years ending after December 31, 1966, and prior to January 1, 1969.

their losses back for three-year periods, namely, taxpayers subject to the general rule, regulated transportation corporations, and insurance companies taxed under subchapter L. The election does not extend to certain banks and financial institutions which are provided with 10-year loss carryback periods, nor does it apply to taxpayers injured by imports, which are allowed 5-year carryback periods. The election will also not apply to foreign appropriation losses which receive no carryback privileges but may be carried over for ten or more years.

The net operating loss carryover election may be made for any loss year which ends after December 31, 1975. The election must be made by the due date, including extensions of time, for filing the tax return for the first loss year to which the election is intended to apply. Once the election is made and applies to any loss year, it is irrevocable. The Secretary is authorized to issue regulations prescribing the manner in which an election is made.

Once an election is made under this provision to use additional carryover years in lieu of carryback years, it will also apply to any net operating losses incurred in subsequent years to which the loss may be carried from the first loss year covered by the election. For example, if a taxpayer covered by the 3-back and 5-forward loss rule has a net operating loss for 1976 and elects the extended 8-year carryover period under these provisions, any net operating loss incurred for taxable years from 1977 through 1984 (assuming no short-period returns are filed) must also be carried over for eight years and no carryback of these losses will be allowed. Similarly, a regulated transportation corporation may not revoke the election for ten years following the first loss year for which an election is effective under this provision.

However, a taxpayer may terminate the election after the 8 (or 10) year period of irrevocability has expired. The Secretary is authorized to issue regulations prescribing the time and manner in which an election may be terminated. Once the taxpayer has terminated the election and reverted back to the carryback and carryover periods authorized under present law, a new carryover election may be made at any time. It is not required that the taxpayer remain under the regular carryback-carryforward rules for any period of time in order to make a new carryover election. However, any new carryover election must be made on a timely basis under the rules generally prescribed for the carryover election.

The amendment is not intended to change the present priority system for absorbing net operating carrybacks and carryovers under which the loss from the earliest loss year is applied first against the income of another year. For example, where a 1976 net operating loss is carried over under the election against income for 1984 and the election has been revoked for a loss in 1985 which is also carried back to 1984, the 1976 loss is to be applied first to reduce income for 1984. Similarly, where there is a net operating loss for 1984 which is subject to the carryover election and the election has been revoked for a 1985 loss, the 1985 loss may be carried back against any previously unabsorbed income for 1982 and 1983, but to the extent it is not used in these carryback years, it is absorbed after the 1984 loss for 1986 and other carryover years.

The committee amendment also provides for measures to prevent abuse of these provisions in corporate acquisition situations where different loss carryback and carryover periods are in effect for the acquiring corporation and the transferor corporation. The amendment amends sec. 381(c) to delegate authority to the Secretary or his delegate to prescribe regulations for these situations. The committee also contemplates the Secretary will similarly draft regulations to provide acceptable rules where corporations with differing loss carryback and carryover periods file consolidated income tax returns.

Effective date

This amendment is effective for net operating losses incurred in years ending after December 31, 1975.

Revenue effect

The amendment will have no revenue effect until 1982.

b. Trafficking in Net Operating Loss Carryovers (sec. 807 of the bill and sec. 382 of the Code)

Present law

In general, if a corporation's assets are acquired by another corporation in certain types of tax-free reorganizations or liquidations, the acquiring corporation succeeds to certain carryovers (including net operating loss carryovers) of the transferor corporation (sec. 381). Where stock of a single corporation is sold in a taxable sale or exchange, no limitatio is ordinarily imposed on continuations of the company's tax attributes.

A number of limitations are imposed, however, in the case of net operating loss carryovers.

Section 382 provides specific limitations on net operating loss carryovers in two general situations: (1) where, within a 2-year period, 50 percent or more of the stock of a corporation is purchased in a taxable transaction (sec. 382(a)); and (2) where, in the case of certain taxfree reorganizations, the shareholders of the loss corporation (whether that corporation is the acquiring corporation or the acquired corporation) have less than a 20 percent stock interest in the acquiring corporation (sec. 382(b)).

The "purchase" rule under section 382(a) applies where one or more of the 10 largest shareholders have increased their stock ownership within a 2-year period, by 50 percentage points or more in a taxable transaction.[1] In such a purchase, if the loss corporation does not continue to carry on a trade or business substantially the same as that conducted before the change in percentage ownership of the stock, the net operating loss carryovers from prior taxable years are completely eliminated.[2] For example, if an individual or group of individuals buy for cash 100 percent of the stock of a loss corporation (which is a mere shell not conducting any trade or business), and subsequently transfer to that corporation a new trade or business, section 382(a) would apply and the loss carryovers of the old corporation would be completely eliminated.

[1] The limitations under section 382(a) also become operative if a person's stock ownership reaches a 50 percentage point increase by redemptions of stock owned by other shareholders

[2] If a buyer increases his stock interest in a loss company by less than 50 percentage points, the net operating losses of the company are not limited by this provision, regardless whether the existing business is continued or changed.

On the other hand, if new owners buy 50 percent or more of the stock of a loss corporation and continue the former trade or business (while perhaps also adding new profit-making assets to the corporation), the new owners can use the entire loss carryovers from years before the change in ownership to offset profits generated by the additional business assets.

Under the "reorganization" rule of section 382(b), if either the transferor or acquiring corporation has a net operating loss which would be a carryover to the first taxable year of the acquiring corporation ending after the date of transfer, and the shareholders of the loss corporation (whether it is the acquiring or the acquired corporation) own less than 20 percent of the stock of the acquiring corporation after the reorganization, the net operating loss carryovers of the loss corporation are reduced proportionately. For each percentage point interest less than 20 percent, the carryover is reduced by 5 percent. Thus, if the shareholders of the loss company obtain at least a 20-percent interest in the acquiring corporation after the reorganization, no reduction of the loss carryovers is made under section 382(b). On the other hand, if the shareholders of the loss corporation have a 10 percent interest in the acquiring company after the reorganization, a reduction of 50 percent of the loss carryovers is made under section 382(b). Unlike the rules for taxable purchases of stock, the limitations on carryovers after taxfree reorganizations do not require that the acquiring company continue to operate the same trade or business which the loss company conducted before the exchange.

Present law also contains a general provision which authorizes the Treasury to disallow a net operating loss carryover where any person or persons acquire control of a corporation for the principal purpose of evading or avoiding Federal income tax by obtaining a carryover which such persons would not otherwise have obtained (sec. 269(a)(1)). A similar rule also applies to tax free acquisitions of one corporation's assets by an unrelated corporation or its shareholders where the acquiring company takes a carryover basis in such assets (sec. 269(a)(2)). For purposes of these rules, control means ownership of at least 50 percent of the total combined voting power of voting stock or at least 50 percent of the total value of all classes of stock.

Reasons for change

In general, the limitations contained in sections 382 and 269 represent an attempt to distinguish between normal changes in the ownership of a going business, where tax attributes such as a net operating loss carryover are incidental, and an acquisition chiefly for the sake of loss carryovers themselves. Present law recognizes, in effect, that tax attributes of a going business may have some financial bearing on the negotiations for a sale of stock or for a merger. The difficulty, however, is that any rules which permit an operating loss to continue despite a sizable change in shareholders or a merged business can in many cases be manipulated for tax avoidance purposes. For example, a free traffic in loss carryovers could result in large windfalls for buyers of stock or assets, who could take advantage of the weak bargaining position of the existing owners of a loss business and acquire large carryovers for only a few cents on the dollar. Such buyers are effectively buying a tax shelter for their expected future profits, whereas if the same persons had used their capital to start a new business on their own, no such loss offsets would be available.

When fixed rules are adopted for an area such as this, it is difficult to envision all possible abuses. It is equally difficult to assure that the rules will achieve equity in all situations. The present rules have defects of both of these kinds. Generally speaking, section 382(a) covers stock acquisitions and section 382(b) covers asset acquisitions. These rules of existing law are not coordinated, however. They also fail to cover some transactions where "trafficking" in loss carryovers can still occur, and there are several loopholes. For example, where enough stock of a loss corporation is purchased for cash, carryovers are lost if the corporation does not continue to carry on the same trade or business. However, losses can still be carried over after a taxfree reorganization whether or not the same trade or business is continued. Conversely, after a purchase of stock, losses can be carried over in full if the former business is continued; but after a reorganization, the loss carryover may be reduced even if the old business is continued.

The purchase limitations come into play where 50 percent or more of the loss company's stock changes hands; but under the reorganization rule there is no limitation (in sec. 382(b)) if the shareholders of the loss company keep at least a 20 percent stock interest.

Where the purchase limitations apply, the loss carryovers are completely disallowed. Where the reorganization rules apply, loss carryovers are reduced in proportion to the change in stock ownership.

The rule that a loss company must continue the same business when new owners buy control of its stock presents special problems. Many critics of this test argue that it is uneconomic to compel new owners of a failing business to continue to operate that business if a new activity can be found in which to make profits. Besides running counter to normal business practice, this test has also been difficult to apply in specific cases, i.e., it has been difficult for taxpayers and for the courts to determine at what point a change in merchandise, location or size of the business should be treated as a change in the business in some cases, the new owners have been permitted to add a different business to the old business, so that the impact of the existing rule is further diluted.

The reorganization limitation does not apply to a "B"-type reorganization (stock for stock). This means that a profitable company can acquire the stock of a loss company in exchange for the profit company's stock, liquidate the loss company after a reasonable interval, and use its loss carryovers without limit against the profit company's future income. Where a profitable company uses a controlled subsidiary to acquire the assets of a loss company for stock in the profitable company, the reorganization rules can be completely avoided because (under present law) the minimum ownership rule for the loss company's shareholders is not applied by reference to the percentage interest which these shareholders have in the profitable company (sec. 382(b)(6)). The parent company can then liquidate the loss company and use all of the loss carryovers or, alternatively, the parent can contribute new profitable businesses to its "loss" subsidiary and absorb the loss carryovers against the future profits.

Section 269 of present law has had some effect in discouraging obvious tax avoidance transactions which seek to exploit the fixed rules of the code in the case of loss carryovers. However, this test requires a subjective inquiry into a taxpayer's motives and is not a completely effective tool for typical transactions. The uncertainty which taxpayers face as to the possible application of section 269, along with the uncertainties under section 382 (such as when a business is continued) itself tends to reduce the price which a buyer of a business will pay and thus often increases his windfall if he can succeed in passing the tests of present law.

The committee has reviewed the circumstances under which limitations should be imposed on net operating loss carryovers, whether originating with the same corporation or inherited from an acquired corporation. The importance of preventing abuse and for closing loopholes is especially important because of the increase in the loss carryover period which corporations will be allowed to elect under another provision of the committee amendment. In light of these factors, the committee has retained the basic provisions of present law in this area, but has made several amendments aimed at further restricting the potential to use these rules for abuse and, on the other hand, also to coordinate the present rules.

Explanation of provision

Purchases, etc. of stock.—In the case of purchases of stock of a loss corporation, the committee amendment changes section 382(a) to focus on changes in stock ownership alone. The continuation of business rule is eliminated. As a result, when the specified increase in stock ownership by a buying group occurs, net operating losses may be limited even if the new owners continue the same trade or business. It will no longer be necessary to make detailed factual inquiries into the different degrees or ways that an existing business can be changed. By eliminating the continuation of business rule for stock purchases, the bill creates a parallel with the existing rules for taxfree mergers.

On the other hand, the bill raises the point at which a purchase of stock will bring limitations into play from 50 to over 60 percentage points.

The all-or-nothing rule for stock purchases is also replaced by a proportionate reduction in the allowable net operating loss carryover as the buyer's interest rises above an increase of 60 percentage points. In this respect the rules for stock purchases are coordinated with the present rules for taxfree transactions (as these rules are also changed by the amendment). Under the amendment, a buyer or group of buyers can purchase for cash up to 60 percent of the stock of a loss corporation and obtain the full available loss carryovers (for the remaining carryover period otherwise available for such losses). If the increase in the buyer's stock ownership is greater than 6 percentage points, however, the net operating loss carryover is reduced by a percentage of the carryover equal to two and one-half percentage points for each point over a 60 percentage point increase that the buyer has acquired.[3]

[3] For example, if the buyer increases his stock ownership during the applicable period by 80 percentage points, the loss carryover will be reduced by 50 percent, i e., 20 percentage points above the 60 percentage point threshold times 2½-50 percent reduction in net operating loss. If the buyer increases his stock ownership by 65 percentage points, the corporation will be permitted to carry over 87.5 percent of its prior net operating losses If the buyer increases his stock ownership by 90 percentage points, only 25 percent of the net operating loss can be carried over.

In applying these rules to stock purchases, the amendment imposes several new restrictions. The period of time during which stock purchases may be made which can bring the loss limitations into play has been increased from 2 to 3 years. The test under which increases in stock ownership are to be measured is changed from a percentage of the fair market value of the stock to an alternative: either the voting power of all classes of voting stock or the total value of all classes of stock. (This is generally the measuring rod used under section 269 of present law.) If the buyer increases his stock ownership by over 60 percentage points of either voting power or value, the loss limitations will begin to operate. If the increase in percentage points exceeds 60 in the case of both voting power and value, the limitations are to apply by reference to whichever increase is the greater.

The amendment also adds a section 351 exchange to the transactions to which section 382(a) applies. (New investors can escape the limitations under the purchase rule in present law by transferring property to the loss corporation in exchange for 80 percent or more of the company's stock, since the present rule applies only where the transferor takes a cost basis in the stock he receives. A section 351 exchange is not now covered because the transferor in such an exchange takes a "substituted" basis rather than a cost basis in the stock he receives.) The amendment also makes clear that any combination of a purchase of stock, redemption or nonrecognition exchange under section 351 will be covered by the rules.

The amendment includes in the taxable years to which section 382 (a) applies the taxable year of the corporation in which an over-60 percentage point increase in stock ownership is completed. Under present law, the limitations do not apply to a net operating loss incurred in the acquisition year itself and which will be a carryover to later years. The amendment changes this rule and brings under the limitations the loss company's net operating loss for the year in which the increase in the buying group's stock exceeds 60 percentage points. (The portion of the loss in that year to be affected is to be determined by reducing the net operating loss in that acquisition year by the same percentage which under this provision applies to loss carryovers from earlier years.

Where a net operating loss in an acquisition year is limited under this new rule, an additional rule is provided to prevent undue hardship. If the new owners continued to hold their stock without change during the following two years, each of these succeeding years would become (because of the 2-year "lookback" to measure increases in stock ownership) years in which an excessive increase in stock ownership occurred. The result would be to disallow or reduce net operating losses incurred in these succeeding two years. To prevent this unfair result, the bill provides in effect that if a person's stock ownership remains unchanged during the first or second year following an excessive change in ownership year, that person will not be treated as having increased his stock ownership during those later years by comparison with a point two years earlier. In this way net operating losses incurred in one or both of these later years will not be reduced under sec. 382(a) by reason of the earlier change in ownership.

A number of other safeguards are also added. The amendment does not change the present provision which makes the constructive ownership rules of section 318 apply to transactions under section 382(a). It is important to add safeguards in this area, however, because of the potential for buyers to manipulate stock instruments which (for example) contain option features under which new investors could purchase convertible bonds or stock in amounts which do not exceed the 60 percentage point level but which can be converted into additional stock in later years so as to exceed the 60 point level. In determining the ownership of stock under this provision, the amendment authorizes the Internal Revenue Service to prescribe rules which specify which stock is to be taken into account in applying the limitations of section 382(a).[4]

Mergers and other taxfree reorganizations.—In the case of mergers and other taxfree reorganizations involving a loss company, the amendment makes no change in the present rule which preserves the net operating loss carryover in full if the loss company's shareholders obtain a minimum stock ownership in the acquiring company, but reduces the carryover if these shareholders fall short of the minimum. The amendment increases the required minimum ownership, however, to 40 percent and reduces the loss carryover by 2½ percentage points for each percentage point less than 40 percent which these shareholders obtain. If the shareholders of the loss company retain at least a 40 percent interest when they sell their stock to new investors for cash, or if they retain at least a 40 percent interest in the acquiring company after a merger or other reorganization, the loss carryovers will survive in full. To the extent their retained interest falls below these levels in either situation, the loss carryovers will be reduced.

The minimum ownership rules under this provision are to be measured by reference to the acquiring company's "participating stock." This is defined to mean voting stock which represents an interest in corporate earnings not limited to a stated amount of money or property, and which is not preferred in any respect (other than as to voting rights) over any other outstanding stock either as to distribution of earnings or distribution of assets on liquidation. The merger rule will thus not be satisfied by giving the loss company shareholders voting preferred stock.

The amendment also closes a gap in present law by making a stock for stock exchange (which is taxfree as a "B" reorganization) subject to section 382(b). In this type of exchange, if the shareholders of the loss company exchange their stock for stock in an acquiring company, the loss shareholders will own stock in the acquiring company which, in turn, will own the loss company as a subsidiary. The percentage limitations of section 382(b) will apply to the shareholders' stock in the acquiring company and the result will affect the percentage of the loss carryovers of the new subsidiary which can be applied against its income after the exchange. These limitations will apply even if the parent later liquidates the subsidiary in a taxfree liquidation (sec. 332). (If the exchange and later liquidation can on the facts be "stepped" together and treated as a "c" reorganization (sec. 368(a)(1)(c)), the losses will also be limited under sec. 382(b)).

[4] Although section 318 already triggers attribution based on an option (sec 318(a)(4)), the Service is to have specific authority under sec. 382(a) to treat convertible securities and other options as equivalent to the underlying stock and otherwise to prevent manipulations of stock structures which readily appear designed to circumvent the specific rules of sec. 382(a).

The amendment also eliminates a rule in present law under which "triangular" reorganization can be used to avoid the limitations in section 382(b). Under present law, if an acquiring company arranges for a controlled subsidiary to acquire a loss company for stock of the parent company, the limitations on loss carryovers are applied by comparing the value of the loss shareholders' stock in the parent company with the value of all the stock of the loss company (sec. 382(b)(6)). If the loss company receives no new assets, however, the loss shareholders will usually be treated as having a sufficient percentage interest (under this rule) to qualify for a full carryover. The amendment changes this rule and requires that the percentage limitations be applied by reference to the loss shareholders' actual percentage interest in the parent company.[5]

The general tax avoidance test.—The committee has not amended section 269 of present law because the application of this general disallowance provision should be retained for transactions not expressly within the fixed rules as changed by the amendment. Section 269 is retained, for example, to deal with "built-in loss" transactions and other exchanges or transfers which are apparent devices to exploit continuing gaps in the technical rules for tax avoidance purposes. The committee believes, however, that section 269 should not be applied to disallow net operating loss carryovers in situations where part or all of a loss carryover is permitted under the specific rules in section 382, unless a device or scheme to circumvent the purpose of the carryover restrictions appears to be present.

The Libson Shops doctrine.—In *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), the Supreme Court, in a case decided under the 1939 Code, adopted an approach to the loss carryover area under which loss carryovers would basically follow the business activities which gave rise to the losses. Considerable uncertainty has existed since this decision as to whether the business continuity approach represents a separate, nonstatutory test for determining carryovers of net operating losses. In view of the changes made in present law in the amendment, the committee believes that the so-called *Libson Shops* approach should have no application to determining net operating loss carryovers after stock purchases or reorganizations in tax years for which the amendment is effective.

Carryover of certain other items.—Under present law, limitations similar to those placed on operating loss carryovers following a reorganization or taxable purchase of stock are imposed on carryovers of unsued investment credits, work incentive credits, foreign taxes and capital losses (sec. 383). The bill amends this provision to eliminate the reference to the continuation of business rule in section 382(a). The changes made by the committee in section 382 are thus incorporated by reference into section 383.

Effective date.—The amended rules relating to taxable purchases, etc. of stock in section 382(a) are to become effective no earlier than the date of enactment of this bill. This means that the "lookback" under section 382(a), as amended, will not have to be made to taxable years beginning before the date on which this bill becomes law. The

[5] This rule will also cover so-called "reverse mergers" of the kind described in sec. 368(a)(2)(E).

date of enactment will be the earliest point to which the lookback will be made from subsequent years.

The new rules limiting net operating loss carryovers to years ending after a tax-free reorganization will apply to reorganizations consummated pursuant to a plan of reorganization adopted after the date of enactment of the bill.

I. CONTINUATION OF CHANGES IN CORPORATE TAX RATES AND INCREASE IN SURTAX EXEMPTION

(Sec. 503 of the bill and sec. 11(b) of the Code)

Present law

Prior to the 1975 Tax Reduction Act, corporate income was subject to a 22-percent normal tax and a 26-percent surtax (for a total tax rate of 48 percent). However, the first $25,000 of corporate income was exempt from the surtax. As a result, the first $25,000 of corporate income was taxed at a 22-percent rate and the income in excess of $25,000 was taxed at a 48-percent rate.

In the Tax Reduction Act of 1975, the surtax exemption was increased to $50,000 and the normal tax was reduced to 20 percent on the initial $25,000 of taxable income. This results in a 20-percent rate on the first $25,000 of income, a 22-percent rate on the next $25,000 of income, and a 48-percent rate on that part of income in excess of $50,000. These changes were extended by the Revenue Adjustment Act of 1975 through June 30, 1976. However, since the increase in the surtax exemption to $50,000 and the reduction of the normal tax on the initial $25,000 of taxable income to 20 percent were extended for only six months, the corporate tax rate is scheduled to revert to the pre-1975 levels on July 1, 1976.

Reasons for change

The temporary changes in the corporate surtax exemption provided by the 1975 Tax Reform Act were adopted for two reasons: First, to grant tax relief to small businesses which are not likely to derive substantial benefits from the liberalizations in the investment credit because they are not capital intensive; and second, to provide temporary tax relief to small business as part of a program of tax reduction designed to help sustain the economy and promote economic recovery. These reasons for increasing the surtax exemption and lowering the normal corporate tax rate continue to apply in the current economic situation.

Explanation of provision

The bill makes permanent the increase in the surtax exemption to $50,000 and the reduction in the normal tax rate on the first $25,000 of corporate income to 20 percent. In addition, the bill makes these provisions applicable to mutual insurance companies in order to correct an oversight in the Tax Reduction Act of 1975.

Effective date

These provisions make the changes in corporate tax rates and the increase in the surtax exemption applicable in the case of all taxable years ending after December 31, 1975. They are also made applicable to mutual insurance companies for taxable years ending after December 31, 1974.

Revenue effect

This provision will reduce budget receipts by $1,676 million in fiscal year 1977, $2,221 million in fiscal year 1978, and $2,771 million in fiscal year 1981.

This change involves an estimated revenue loss of $1.0 billion in 1976. In calendar year 1977, the revenue loss will amount to an estimated $2.14 billion—$1.81 billion for the increase in the surtax exemption and $330 million for the reduction in the normal tax rate to 20 percent on the first $25,000 of corporate income. In accordance with the provision's objective, the larger part of the resulting tax reductions will accrue to small corporations. For example, about 63 percent of the aggregate tax reductions resulting from the liberalized surtax exemptions and the decrease in the normal tax rate provided by the bill will accrue to corporations with incomes of less than $100,000.

J. TAX TREATMENT OF FOREIGN INCOME

1. Exclusion for Income Earned Abroad (sec. 1011 of the bill and secs. 36 and 911 of the Code)

Present law

U.S. citizens are generally taxed by the United States on their worldwide income, with the provision of a foreign tax credit for foreign taxes paid.[1] However, U.S. citizens who are working abroad may exclude from their income up to $20,000 of earned income for periods during which they are present in a foreign country for 17 out of 18 months or during the period they are *bona fide* residents of foreign countries (sec. 911). In the case of individuals who have been *bona fide* residents of foreign countries for three years or more, the exclusion is increased to $25,000 of earned income.

The above exclusions do not apply to employees of the U.S. Government working abroad. However, present law provides that certain special governmental allowances given to these employees are excluded from gross income and are not taxed by the United States (sec. 912). These allowances, which include housing, cost-of-living, education and travel allowances (established by various statutes) are exempt under the tax laws. (Allowances received by members of the armed forces are exempted under provisions of law outside of the Internal Revenue Code.) Any employee is entitled to exclude from gross income lodging furnished by the employer on the business premises if the employee is required to accept it as a condition of employment (sec. 119).

Reasons for change

The committee believes that the exclusion for income earned abroad under present law should be retained so that the competitive position of U.S. firms abroad is not jeopardized. Therefore, the committee does not agree with the provision in the House bill which would, with certain exceptions, phase out the exclusion over four years. However, the committee's attention has been called to the presence of unintended results under present law. For example, compensation is excluded under section 911 even though it is not subject to tax by the foreign country where the employee is employed if the compensation is paid outside that foreign country (e.g., if the salary is sent to a bank outside of that country).

In those cases where a foreign tax is paid by the U.S. citizen, that tax is creditable directly against any U.S. tax that might otherwise exist on income above the $20,000 or $25,000 excludable limits. This combination of an exclusion of $20,000 or $25,000 of income, plus the allowance of the full foreign tax credit attributable to all income (including the excluded income) gives taxpayers who do pay tax to foreign governments in effect a double benefit, in that they can offset the foreign taxes paid on the excluded income against any U.S. tax

[1] A foreign tax credit is not allowed to those individuals who take the standard deduction.

which may be due on additional foreign income. The result is that $40,000 or more of earned income can be exempted from U.S. tax if the U.S. employee pays any significant income tax to the foreign government.

In addition, compensation in excess of the excluded amount is taxed by the United States at a marginal rate that would apply to an employee who had not earned the excluded amount. The committee feels that this treatment is inconsistent with our progressive tax system and that the marginal rate applicable to the employee having the advantage of the exclusion should take into account the excluded amount.

The committee is also concerned over the problem that is encountered by individuals working overseas, particularly in remote areas of less-developed countries. Quite often housing costs for employees near or on construction sites is very expensive to provide. To the extent that the employee is required to take the cost of the housing into income, the employee can have a very high tax burden although he has received little or no apendable income.

Explanation of provisions

The committee amendment retains the exclusion for certain earned income of individuals abroad but makes three modifications in the computation of the exclusion. First, the amendment provides, as did the House bill, that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that are excluded from gross income under the earned income exclusion. Thus, foreign income taxes that are paid on excluded amounts are not to be creditable or deductible.

Second, the amendment provides that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded. For the purpose of determining the rate brackets applicable to the nonexcluded income, the taxpayer is entitled to subtract those deductions which would be otherwise disallowed by reason of being allocable to the excluded earned income. Thus, for example, if a taxpayer has $20,000 of gross income which is excluded under the earned income exclusion and also has $5,000 of deductions which are not allowable by reason of the deductions being allocable to the excluded earned income, the taxpayer is treated as having $15,000 of taxable income for purposes of computing the tax rates on the nonexcluded income.

Since earned income is now subject to an exclusion with the other income being taxed at the higher brackets; any foreign tax credits disallowed bv reason of being allocable to the excluded earned income are to be considered as those taxes paid on the first $20,000 or $25,000 of excluded income.

Third, the amendment makes ineligible for the exclusion any income earned abroad which is received outside of the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country. The tax avoidance purpose does not have to be the only purpose for receiving the money outside of the country in which earned, nor does it have to be the principal reason for receiving the money outside of that country. It is sufficient that it be one of the purposes. It is the committee's intention that the fact that the country in which the income is earned does not tax amounts received outside of the country be viewed as a strong indication of a tax avoidance purpose.

The committee's amendment provides, as did the House bill, that individuals taking the standard deduction are to be allowed the foreign tax credit.

The committee's amendment provides an exclusion for certain housing which is either furnished to the employee by the employer or reimbursed by the employer. The exclusion is limited to the amount by which the State Department allowance in that particular geographic locale exceeds the cost of comparable housing in Washington, D.C. To the extent that any amounts are excluded under this provision, the exclusion under section 911 is to be reduced on a dollar-for-dollar basis. The committee also is aware that questions have been raised as to the entitlement to the exclusion for housing furnished to employees on the employer's premises when the employee is employed on a large construction project in a remote area. Quite often no housing, other than that furnished by the employer, is available. Your committee expects that the Internal Revenue Service will administer the exclusion of present law in as liberal a manner as possible given the confines and limitations of the existing provision so that as many employees as possible who are involved in overseas construction projects will be entitled to this exclusion.

Effective date

These provisions are effective for taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by $30 million in fiscal year 1977, $28 million in fiscal year 1978, and $28 million in fiscal year 1981.

2. U.S. Taxpayers Married to Nonresident Aliens (sec. 1012 of the bill and secs. 879, 891, 6013 and 6073 of the Code)

Present law

Under present law, a husband and wife may file a joint income tax return even though one of the spouses has no gross income or deductions. However, a joint return may not be made if either the husband or the wife at any time during the taxable year was a nonresident alien. Under present law, nonresident aliens are generally required to file estimated tax returns by April 15 of the year in question, although they have until June 15 to file the income tax return for the previous year.

Reasons for change

As a rule, a husband and wife find it desirable to file a joint return since it generally results in a lower aggregate tax liability than if they each filed separate returns of their own income and deductions. Taxpayers are encouraged to file joint returns due to the fact that it eliminates the administrative problems of otherwise having to allocate income and deductions between married taxpayers.

The inability of a husband and wife to file a joint return where one of them is a nonresident alien has resulted in the possibility of a heavier tax burden being placed upon this group of taxpayers than other married taxpayers. For example, even though a joint return is not allowed, the spouse who files a tax return is required to use the higher rate table for married individuals filing separately. In addition, these married individuals cannot obtain the benefits of the 50-percent maximum tax on earned income because married taxpayers must file a joint return in order to obtain the benefits of that provision. There are approximately 10,000 U.S. taxpayers who are married to nonresident alien individuals.

These disadvantages under the U.S. tax laws are, however, offset by a number of tax advantages for certain of these taxpayers. First, the foreign source income attributable to the nonresident alien spouse is not subject to any U.S. taxation. Second, if the taxpayers are subject to community property rules, one-half of the earned income of the taxable spouse is treated as being the income of the nonresident alien spouse and is not subject to U.S. taxation if it is from foreign sources.

Nonresident alien individuals who are required to file declarations of estimated income tax for a taxable year must file two months before the time required for filing a return of income for the previous taxable year, while domestic taxpayers may file the declaration at the time the return for the previous year is due. It is normally helpful to compute tax liability for the previous year before estimating the income tax for the current year. However, nonresident aliens must compute their estimated tax two months prior to the due date of their return for the prior year.

Explanation of provisions

The committee amendment allows a U.S. citizen or resident married to a nonresident alien to file a joint return provided that an election is made by both individuals to be taxed on their worldwide income. The nonresident alien is treated, in effect, as a resident of the United States for purposes of the income tax laws. A requirement of the election is that the husband and wife agree to supply all the necessary books and records and other information pertinent to the determination of tax liability; failure to do so could result in termination of the election by the Secretary.

The election applies for the taxable year for which made and for all subsequent years until terminated. However, the election does not apply in a taxable year in which neither spouse is a U.S. citizen or resident at any time during the taxable year.

The election continues until terminated. Either spouse may revoke the election for any taxable year so long as the revocation is made prior to the prescribed time for the filing of the income tax return for such year. The election is terminated in the event of the death of either spouse or the legal separation of the spouses under a decree of divorce or of separate maintenance. In the event of the death of either spouse, the election will ordinarily terminate for the year of the surviving spouse following the year in which the death occurred. However, if the surviving spouse is a U.S. citizen or resident who, for years subsequent to the death of the spouse, is entitled to use the joint return rates (as provided under secs. 1(a)(2) and 2), the election will not terminate until the close of the last year for which joint return rates may be used. In the event of legal divorce or separation, the election terminates as of the beginning of the taxable year in which the divorce or separation occurs.

The Secretary may terminate an election if he determines that either spouse has failed to keep adequate tax records, to give the IRS adequate access to such records, or to supply such other information as may be reasonably necessary to ascertain the taxpayer's income tax liability for the taxable year.

If an election is terminated for any two individuals for any of the reasons stated above, neither of them will be eligible to make the election for any subsequent taxable year. For example, if a divorced individual, who had previously made the election, were to remarry, he or she would not be eligible to make the election.

The above rules apply in the case of alien individuals who do not become residents of the United States. The committee amendment provides a special rule for a nonresident alien individual who becomes a resident of the United States at the close of the taxable year if married to a citizen or resident of the United States. Present law prevents this couple from filing a joint return, since they both were not citizens or residents of the United States for the entire taxable year.

The committee amendment provides that a nonresident alien who at the close of a taxable year is a U.S. resident and is married to a U.S. citizen or resident may elect with the other spouse to be eligible for the joint return provision. In that case, the spouse who was a nonresident alien for the first part of the year is treated as a resident of the United States for the entire taxable year for purposes of the income tax law and thus is taxable on his worldwide income. Since this provision is a limited exception for individuals when they first become residents of the United States, the election does not apply to any subsequent taxable year, and the taxpayers are not eligible to make a second election for any such subsequent year.

The committee amendment makes certain community property laws inapplicable for income tax purposes where the election is not made. Earned income of a spouse, other than trade or business or partnership distributive share income, is treated as the income of the spouse whose services generated such income. Trade or business and partnership distributive share income subject to community property laws will receive the same treatment as that provided under section 1402 (a)(5) (defining net earnings from self-employment). Under section 1402(a)(5)(A), trade or business income (other than that derived by a partnership) which is treated as community income is treated as the income of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case the income of the trade or business is treated as that of the wife. Under section 1402(a)(5)(B), any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership which is community income or loss is treated as the income or loss of such partner, and no part of such distributive share is attributed to the other spouse.

Community income derived from separate property of one spouse (and which is neither earned income, trade or business income, nor partnership distributive share income) is treated as the income of that spouse. All other community income is treated as provided by the applicable community property law.

The above rules are identical to the House bill.

In addition, however, the committee amendment provides for a delay in the time for filing a declaration of estimated tax for a taxable year by certain nonresident alien individuals until the time required for filing a return of income for the prior taxable year. The amendment provides that in the case of nonresident alien individuals who are not subject to wage withholding, the due date for filing the estimated tax return is not to be any earlier than the due date for the tax return.

Effective dates

The provisions of the bill pertaining to the election to be treated as residents of the United States apply to all open taxable years beginning after December 31, 1971. (The House bill would have been applicable with respect to taxable years ending on or after December 31, 1975). The provisions of the bill pertaining to the tax treatment of certain community income, and to the due date for filing estimated tax returns, apply to taxable years beginning after December 31, 1976.

Revenue effect

This section of the amendment it is estimated will result in a decrease in budget receipts of $5 million dollars annually.

3. Income of Foreign Trusts and Transfers to Foreign Trusts and Other Foreign Entities (secs. 1013 to 1015 of the bill and secs. 643(a)(b), 668, 670, 679, 1056, 1491, 1492, 6048, and 6677 of the Code)

Present law

Under present law, the income of a trust is taxed basically in the same manner as the income of an individual, with limited exceptions (sec. 642). Just as nonresident alien individuals are generally taxed only on their U.S. source income other than capital gains[2] and on their income effectively connected with a U.S. trade or business (and not on their foreign source income), so any trust which can qualify as being comparable to a nonresident alien individual is generally not taxed on its foreign source income. If a trust is taxed in a manner similar to nonresident alien individuals, it is considered (under sec. 7701(a)(31)) to be a foreign trust.

The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, Internal Revenue Service rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[3] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and thus is a foreign trust.

Under present law, grantors and other persons are treated as the owner of a trust (under the grantor trust rules) if they have certain

[2] Sec. 841 of this bill provides an exception to the rule that nonresident alien individuals (and thus comparable trusts) are taxed on their U.S. source income. That provision exempts certain U.S. source interest of nonresident aliens from U.S. taxation.

[3] For example see Rev. Bull. 60–181 (C.B. 1960–1, 257) and *B. W. Jones Trust* v. *Commissioner*, 46 B.T.A. 531, aff'd 132 F. 2d 914.

powers or interests in the trust. The grantor trust rules which tax the income of those trusts to the grantor (see secs. 671 to 678) apply equally to foreign and domestic trusts. If a U.S. grantor establishes a foreign trust which comes within these provisions, the worldwide income of that trust is taxed by the United States to the grantor.

If a U.S. taxpayer is a beneficiary of a foreign trust, distributions to him are taxed in basically the same manner as are distributions to a beneficiary of a domestic trust. Distributions of ordinary income received from foreign trusts which can accumulate income are subject to the same throwback rules (sec. 668) which apply to domestic trusts. Under these rules a beneficiary determines his tax on a distribution of income earned by the trust in an earlier year either under the "exact method" or under the alternative three-year "shortcut method." Also, distributions of capital gain income from a foreign trust are treated similarly to such distributions from domestic trusts (i.e., the income is excluded from distributable net income [4] and is taxed under the special capital gains throwback rules (sec. 669)), but only if the foreign trust is created by a foreign person. If a foreign trust is created by a U.S. person, gains from the sale or exchange of capital assets are included in the distributable net income and thus are treated as received by a beneficiary proportionally with any ordinary income earned by the trust in the same year. This exception favors foreign trusts created by U.S. persons over domestic trusts and foreign trusts created by foreign persons because a beneficiary can receive a distribution of capital gain income, which is taxed at a lower rate, without requiring the trust first to distribute all of its ordinary income. Under present law, any capital gains income retains its character in the hands of the beneficiary, thus being eligible for the capital gains deduction (under sec. 1202) upon the distribution of the income.

Regardless of whether a trust is a foreign trust, the amount of any income distribution to a U.S. beneficiary out of accumulated income of the trust is increased by the amount of foreign and U.S. taxes paid by the trust (sec. 666(b)). A foreign tax is thus deemed distributed to a beneficiary with a distribution of income and may be used as the basis for claiming a foreign tax credit against any U.S. tax on that income (sec. 901(b)).

In addition to the above provisions which govern the taxation of foreign trusts, present law imposes (sec. 1491) an excise tax of 27½ percent on certain transfers of property to foreign trusts, as well as to foreign corporations (if the transfer is a contribution to capital), and to foreign partnerships. Under present law the excise tax is imposed on all transfers of stock or securities to such an entity by a U.S. citizen, resident, corporation, partnership or trust. The amount of the excise tax is equal to 27½ percent of the amount of the excess of the value of the stock or securities over the adjusted basis in the hands of the transferor.

Reasons for change

The rules of present law permit U.S. persons to establish foreign trusts so that funds can be accumulated free of U.S. tax. Further, the funds of these foreign trusts are generally invested in countries which

[4] The effect of excluding capital gains from distributable net income is to treat such income as being received by a beneficiary only after all ordinary income for all years of the trust has been distributed.

do not tax interest and dividends paid to foreign investors, and the trusts generally are administered through countries which do not tax such entities. Thus, these trusts generally pay no income tax anywhere in the world. Although the beneficiaries are taxed (and the throwback rules are applied) upon any distributions out of these trusts, nevertheless the use of foreign trusts permits a grantor to provide a tax-free accumulation of income while the income remains in the trust. The committee believes that allowing this tax-free accumulation of income is inappropriate and provides an unwarranted advantage to the use of a foreign trust over the use of a domestic trust. Accordingly, the committee amendment provides that where there is a U.S. grantor the income of a foreign trust is taxable to him if the funds are being accumulated for a U.S. beneficiary. The committee amendment also provides for an interest charge on the amount of any tax paid by a U.S. beneficiary in cases where the income of the trust is not taxable to a U.S. grantor.

In addition, elsewhere in this bill the committee has made a number of changes in the treatment of domestic trusts (see sec. 708 of the amendment). These changes, particularly the modification of the throwback rules and the elimination of the character of capital gains upon accumulation distributions to beneficiaries, are intended to simplify the administration of the tax laws. Adjustments in the rules applicable to foreign trusts must be made in light of these changes in order to prevent foreign trusts from receiving relatively advantageous tax treatment.

A final problem that has come to the committee's attention relates to the effectiveness of the provision of the Internal Revenue Code providing for a 27½ percent excise tax on certain transfers to foreign entities, including foreign trusts. The excise tax was intended to prevent U.S. taxpayers from transferring appreciated property to foreign trusts or other foreign entities without payment of a capital gains tax. However, under present law the excise tax of 27½ percent of the amount of appreciation is less than the maximum capital gains tax on individuals (which can be as high as 35 percent). Furthermore, the excise tax provision has been interpreted by some tax advisors to exclude transfers to foreign entities to the extent that the entity provides some consideration to the transferor. For example, a U.S. taxpayer can transfer appreciated stock to a trust established by him and can receive in return from the trust a private annuity contract or other deferred payment obligation.[5] The committee believes it is appropriate to tax a transfer of assets in these situations.

Explanation of provisions

The committee amendment includes three separate sets of provisions which revise the present treatment of foreign trusts. First, a

[5] Since the contract is viewed as consideration for the assets transferred, section 1491 has been interpreted by some tax advisers not to apply to the transfer. Under this view, the transferor can transfer an asset to a foreign trust and cause it to be sold without payment of tax and can receive, in return, annual payments which are taxed over a number of years. The effect of this transaction is that the transferor defers payment of a substantial amount of tax attributable to the sale of the appreciated asset and obtains the benefit of a tax-free accumulation of the proceeds of the sale. The committee believes that any policy in favor of permitting deferral of tax in private annuity transactions should not apply to a private annuity transaction with a foreign trust. These trusts have limited assets, so that if the transferor outlives his life expectancy the trust will often be unable to continue annuity payments, and if the transferor dies prematurely his beneficiaries receive the remaining trust assets. These facts make the transaction quite different from a conventional private annuity.

foreign trust, the corpus of which is, in whole, or in part, transferred to the trust by a U.S. person and which has a U.S. beneficiary, is made subject to a new grantor trust provision. This provision generally taxes the income of such a trust to the U.S. person transferring property to the trust. Second, in the case of a foreign trust the income of which is not taxed to the grantor, the taxation of any distribution to a U.S. beneficiary is revised by changing the rules for taxing capital gains income and by adding an interest charge on accumulation distributions. Finally, the excise tax on transfers to foreign entities, such as foreign trusts, is expanded in its scope and the rate of the excise tax is increased.

The committee amendment with respect to grantor trust rules are substantially the same as the corresponding provisions in the House bill.

Grantor trust rules.—The committee amendment contains a new grantor trust provision under which, in general, any U.S. person transferring property to a foreign trust which has a U.S. beneficiary is treated as owner of the portion of the trust attributable to the property transferred by the U.S. person.[6] The committee amendment specifically excludes trusts described in section 404(a)(4) (relating to employee trusts created or organized outside of the United States) from this new provision. Any U.S. person treated under this provision as owner of a portion of a trust is taxed on the income of that portion of the trust in the same manner as an owner of a trust is taxed under the existing grantor trust rules (part IE of subchapter J of the Internal Revenue Code). If another U.S. person would be treated as owner of the same portion of the trust under the grantor trust rule (sec. 678 which applies to persons other than the grantor), that other person is not to be treated as owner of that portion of the trust for tax purposes. For purposes of determining the portion of a trust over which the U.S. grantor is treated as owner, loans to the trust by the grantor or by any other person shall be disregarded.[7]

The new grantor trust provision applies to transfers of property by any U.S. person, as that term is defined in the Internal Revenue Code (sec. 7701(a)(30)). Thus, transfers by U.S. citizens or residents, by domestic partnerships, by domestic corporations, and by estates or trusts which are not foreign estates or foreign trusts are included. However, transfers by U.S. persons which take place by reason of the death of the U.S. person are not included. For example, the income of a foreign testamentary trust created by a U.S. person is not taxed to the estate of the U.S. person. In addition, an inter vivos trust which is treated as owned by a U.S. person under this provision is not treated as owned by the estate of that person upon his death.

These rules apply only for income tax purposes. Whether the corpus of the inter vivos trust is included in the estate of the U.S. person depends on the estate tax provisions of the Code. Such provisions, as well as the gift tax provisions of the Code, are unaffected by this amendment.

[6] This provision does not affect the definition of a foreign trust provided in sec. 7701(a)(31) of the Internal Revenue Code since the foreign source income of a grantor trust is taxed to the owner and not the trust itself.

[7] For example, if a U.S. person transfers $10 to a foreign trust having U.S. beneficiaries, and also lends $90 to that trust, he shall be treated as the owner of trust income attributable to $100. For this purpose, if a U.S. person makes a deposit in a bank (or a contribution to another entity) and that deposit (or contribution) is followed (or preceded) by a loan of a similar amount to a foreign trust, the U.S. person is to be considered to have made the loan directly to the trust.

The new grantor trust provision applies to transfers of property by U.S. persons whether the transfers are accomplished directly or indirectly. Transfers by a domestic or foreign entity in which a U.S. person has an interest may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control over the entity to direct the transfer by the entity rather than himself.[8] If a foreign trust borrows money or other property the repayment of which is guaranteed by a U.S. person, that U.S. person is treated as having transferred to the trust the property to which the guarantee applies. For this purpose, a guarantee may consist of any understanding, formal or informal, by which payment of an obligation is assured.

Transfers by U.S. persons are subject to the grantor trust provision regardless of whether the transfers are made without receipt of consideration from the trust or whether the transfers constitute a sale or exchange (including a tax-free exchange) of the property to the trust. However, the amendment provides an exception for transfers of property to a foreign trust pursuant to a sale or exchange of the property at its fair market value if, in the transaction, the transferor realizes and recognizes all of the gain at the time of the transfer or if the gain is taxed to the transferor as provided in section 453 (providing for installment reporting of gains under certain circumstances). If this exception applies, the transferor is not treated as owner of any portion of the trust by reason of that transfer. But the transferor is treated as an owner of the trust if gain is realized from the transaction and if the transferor reports the gain as an open transaction or as a private annuity.

A U.S. person transferring property to a foreign trust is treated as an owner of the trust only if the trust has a U.S. beneficiary. The committee amendment provides that a trust is treated as having a U.S. beneficiary if the trust instrument includes existing U.S. persons as beneficiaries or if the trust instrument (taken together with any related written or oral agreements between the trustee and persons transferring property to the trust) gives to any person the authority to distribute income or corpus to unnamed persons generally or to any class of persons which includes U.S. persons. This authority exists, for example, if any person (whether or not adverse to the grantor) has the power to appoint U.S. beneficiaries or to amend the trust instrument in such a way as to include U.S. beneficiaries. A trustee (or other person) can have authority to distribute income or corpus to unnamed persons and can avoid being treated as having a U.S. beneficiary if terms of the trust (which cannot be amended) provide that no part of income or corpus of the trust may be paid or accumulated for the benefit of a U.S. person. Of course, the fact that a named

[8] For example, if a U.S. person transfers property to a foreign person or entity and if that person transfers that property (or its equivalent) to a foreign trust that has U.S. beneficiaries, the U.S. person transferring the property to the foreign person or entity is treated as having made a transfer to a foreign trust unless it can be shown that the transfer of property to the trust was unrelated to the U.S. person's transfer of property to the foreign person or entity. A similar rule applies to transfers (including certain deferred sales) through domestic entities or persons. For example, if a U.S. person transfers property to a domestic trust or corporation and that entity subsequently transfers the same or equivalent property to a foreign trust, the U.S. person may be treated as having made a transfer of property indirectly to a foreign trust. Moreover, transfers to a domestic trust which subsequently becomes a foreign trust may be regarded as indirect transfers to a foreign trust.

foreign beneficiary could become a U.S. person by residency or citizenship does not cause a foreign trust to be treated as a grantor trust before the event actually occurs.

In addition, the committee amendment provides that a trust is treated as having a U.S. beneficiary for any taxable year if, assuming the trust terminated in that taxable year, any part of the remaining income or corpus of the trust could be paid to or for the benefit of a U.S. person. The same rules that apply to determine whether a trust has a U.S. beneficiary in any year during its existence are to apply to this termination provision.[9]

The committee amendment provides that a year-by-year determination be made of whether or not a trust has a U.S. beneficiary. If a foreign beneficiary becomes a U.S. person (and thus becomes a U.S. beneficiary), the new grantor trust provision applies to the transferor beginning with the transferor's first taxable year in which the foreign person becomes a U.S. beneficiary.[10]

The committee amendment provides a special rule for cases in which a foreign trust acquires a U.S. beneficiary in any taxable year and has undistributed net income (i.e., accumulated income which would be taxable to a beneficiary upon distribution) as of the close of the immediately preceding taxable year. In such a case, the transferor of property to the trust is treated as having additional income in the first taxable year in which the taxpayer is treated as an owner of a portion of the trust. The amount of the income is equal to the undistributed net income for all prior taxable years to the extent that such undistributed net income remains in the trust at the end of the last taxable year before the trust had a U.S. beneficiary.[11]

The committee amendment provides for attribution rules for determining whether a trust has a U.S. beneficiary. A trust having a foreign corporation as a beneficiary is treated as having a U.S. beneficiary if more than 50 percent of the total combined voting power of all classes of stock is owned or considered to be owned by U.S. shareholders under the rules for determining stock ownership of controlled foreign corporations. Similarly, if a foreign trust has a foreign partnership as a beneficiary, the trust is treated as having a U.S. beneficiary if any U.S. person is a partner (directly or indirectly) of the partnership. Finally, if a foreign trust has as a beneficiary another foreign trust or a foreign estate, the first trust is considered to have a U.S. beneficiary if the second foreign trust or the foreign estate has a U.S. beneficiary.

The amendment also provides that persons subject to the grantor trust rule are to file an annual information return with the Internal

[9] For example, if any person has a power to appoint a remainder beneficiary or to amend the trust provisions to name such a beneficiary, the trust is treated as having a U.S. beneficiary. Also, if under the law applicable to the trust, distributions are required to be made to U.S. persons (notwithstanding the trust instrument), the trust is treated as having a U.S. beneficiary.

[10] For example, if a trust names X, a French citizen and resident, plus X's offspring as beneficiaries, the trust would have no U.S. beneficiaries until X's offspring or X himself became a U.S. person.

[11] For example, if a trust instrument provides that income is to accumulate until distributed to Swiss citizen X's offspring, the amount accumulated is not taxed to the transferor of the property as long as the offspring are not U.S. persons. However, if any of X's offspring become a U.S. person, the transferor of the property is treated as having income in the amount of the undistributed net income for all taxable years (attributable to the property transferred) remaining in the trust at the end of the last taxable year before the year in which that offspring became a U.S. beneficiary. For this purpose any power over a trust (described by secs. 671–678) held by a nonresident alien shall be ignored.

Revenue Service, setting out such information as is prescribed by the Secretary. A penalty equal to 5 percent of the corpus of the trust is provided for failure to file this return.

Taxation of beneficiaries of foreign trusts.—In those cases where the income of a foreign trust is not taxed to the grantor under the grantor trust rules,[12] the committee amendment provides for an interest charge based on the length of time during which that tax was deferred because of the trust's accumulation of income. This charge is in addition to any tax which is incurred by beneficiaries receiving distributions from foreign trusts not taxed under the grantor trust rules. The interest charge is to equal 6 percent per year times the amount of tax imposed on the beneficiary (after reduction for any foreign tax credits attributable to the distribution and for any U.S. taxes paid by the trust). It is not compounded.[13]

In cases where the distribution in one year consists of amounts earned in more than one year, the interest charge is calculated by averaging the years in which amounts were actually earned (even though the amount of income tax to be paid by the beneficiary is determined under the new five-year throwback rules provided for under sec. 708 of this amendment) and computing the entire charge based on that average period.[14]

The interest charge is to be calculated on an annual basis. Amounts deemed to be distributed to a beneficiary in year 1 but actually distributed in year 2, carry one full year's interest charge, regardless of when in year 1 the amounts were earned by the trust or when in year 2 the amounts were distributed.

The total of the interest charge plus the tax incurred is limited by the amount of the distribution (not including any amounts deemed distributed as U.S. or foreign taxes paid by the trust). Thus, in no case can the interest charge plus the tax on the distribution exceed the amount actually distributed. The amount of interest paid or assessed under the provision is not deductible as interest for Federal tax purposes and may itself be subject to interest charges in cases of late payment.

The interest charge applies to distributions made in taxable years of beneficiaries beginning after December 31, 1976. Solely for purposes of the interest charge, undistributed net income existing in a foreign trust as of the beginning of the first taxable year beginning after December 31, 1976, is treated as having been earned by the trust in that taxable year. Thus, any future distribution out of earnings deemed to have been distributed prior to taxable years beginning after December 31, 1976, bears an interest charge beginning with the first taxable year beginning after December 31, 1976.

[12] For example, if the U.S. grantor of the trust has died or if the trust has a foreign grantor, the new grantor trust rules do not apply.

[13] For example, the tax on a distribution in year 8 of amounts earned in year 2 (and thus deemed to be distributed in year 2) is subject to an interest charge of 6 percent for 6 years, or a total of 36 percent of the amount of tax.

[14] For example, if amounts distributed in year 8 were earned in years 2, 3, and 4, the number of years for which interest is charged is determined first by calculating the number of years of accumulation for each year in which amounts distributed were originally earned (in this case 8—2 or 6 years for amounts earned in year 2, 8—3 or 5 years for amounts earned in year 3, and 8—4 or 4 years for amounts earned in year 4). The total of these number of years of accumulation (here 6+5+4, or 15 years) is then divided by the number of different years from which the amounts distributed were earned (3 different years). The result (5 years) is the average number of years of accumulation and is multiplied by the 6 percent interest rate to produce the total percentage of interest (30 percent) which is applied against the amount of the tax.

The interest charge provided by the committee's amendment is identical to that provided by the House bill.

Under the provisions of the bill, U.S. beneficiaries receiving distributions from foreign trusts not taxed under the grantor trust rules are subject to the new five-year throwback provisions established for beneficiaries of trusts generally (see sec. 708 of the amendment). Thus, the exact throwback rules and the three-year shortcut method for taxing ordinary income, plus the capital gains throwback rules, no longer apply to distributions from foreign trusts.

In addition, the new multiple trust rules (of sec. 708 of the amendment) apply equally to foreign trusts as to domestic trusts. A beneficiary receiving distributions attributable to the same taxable year from three or more trusts is not permitted to gross up his distributions by the amount of trust tax paid or to receive a tax credit for distributions from any trust beyond the first two trusts. However, the bill limits to domestic trusts the provision permitting trusts to accumulate income for unborn children or children under the age of twenty-one and to avoid the throwback rules upon later distribution of the accumulated income; the throwback rules apply to distributions from foreign trusts without regard to the age of any beneficiary.

Finally, in keeping with changes made applicable to domestic trusts, the bill provides that the character of capital gains is to be disregarded for purposes of taxing accumulation distributions to the beneficiary. Furthermore, in the case of distributions of capital gain income from foreign trusts, the provision of present law requiring that the capital gain be allocated to income and not to corpus if the foreign trust is created by a U.S. person has been expanded to apply to all foreign trusts. The effect of ending the separate characterization of income from capital gain in the new throwback provisions and of allocating to income all capital gains in foreign trusts is to treat income from capital gains the same as ordinary income when it is distributed from a foreign trust as an accumulation distribution. No exclusion of 50 percent of net long-term capital gains is available to the beneficiary of a foreign trust upon such a distribution. However, if a foreign trust has undistributed net income at the end of the last taxable year ending before January 1, 1977 (the House bill provided for January 1, 1976), which is attributable to income from capital gains from any prior taxable year, the trust is permitted to reduce undistributed net income as of the beginning of the next taxable year by the amount of the 50 percent of long-term capital gain exclusion which would be permitted to any beneficiary upon the distribution of all undistributed net income. However, no reduction in undistributed net income is permited for foreign trusts attributable to income from capital gains earned after the effective date of these provisions.

Excise tax on transfers to foreign entities.—The committee's amendment increases the excise tax imposed under present law (sec. 1491) on certain transfers of property to foreign trusts, foreign corporations, and foreign partnerships from 27½ percent to 35 percent. In addition, the scope of the tax has been altered. First, the tax is to apply to transfers of all types of property rather than only to transfers of securities. Second, the tax is to apply only to the amount of gain which is not recognized by the transferor at the time of the transfer.

Under present law, it is not clear whether the provision applies to all transfers of appreciated securities regardless of whether gain is recognized. Some tax advisors have interpreted the provision to apply primarily to donative transactions. The excise tax as amended by the bill is to apply to all transfers (including tax-free exchanges) whether or not at fair market value and whether or not the transfer is made with donative intent. However, in the case of transfers to corporations, the provision is to apply only to transfers treated as paid-in surplus or as a contribution to capital. The amount against which the excise tax is applied is to be reduced by the amount of gain recognized by the transferor upon the transfer of the property. Thus, all sales and exchanges (including tax free exchanges, installment sales, and private annuity transactions), regardless of how any gain on these transactions is reported, are within the scope of the excise tax provision. But to the extent the transferor immediately recognizes gain in the transfer, the amount against which the tax is applied is reduced.

The committee's amendment adds a new section to the Code under which a taxpayer may elect to treat a transfer described above as a sale or exchange of the property transferred and to recognize as gain on such transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor. Thus, to the extent that gain is recognized pursuant to the election, the transfer is not subject to the excise tax, and normal rules will apply to increase the basis to the transferee by the amount of gain recognized.

As under present law, the excise tax does not apply if the transferor can establish to the satisfaction of the Secretary that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. It is contemplated that ordinary business sales or exchanges involving an unrelated foreign trust will normally be determined not to be in pursuance of a plan of tax avoidance.[15] However, where the transferor of the property is directly or indirectly related in some way to the foreign entity receiving the property, then under normal circumstances, the transfer could be one in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Such a transfer would thus normally be subject to the excise tax.

A final change in the excise tax made by the amendment provides that transfers to foreign entities to which section 367 of the Code applies (dealing with reorganizations and transfers involving foreign corporations) are not to be subject to the new 35 percent excise tax. The taxation of any transfer to which section 367 applies, as that section is amended by this bill (see sec. 1052 of the amendment), is determined entirely by that section and the regulations and rulings of the Internal Revenue Service under that section.

The excise tax changes provided by the committee's bill are identical to those in the House bill, except for the addition of the election to recognize gain in lieu of paying the excise tax.

[15] For example, a sale of real estate to an unrelated real estate trust in a case where the gain from the sale is reported on the installment basis should, under normal circumstances, be considered not a transfer in pursuance of a plan of avoidance of Federal taxes and thus would not normally be subject to the 35 percent excise tax.

Effective dates

The new grantor trust rule is to apply to transfers of property to foreign trusts after May 29, 1974. However, the rule is to apply to income received in taxable years beginning after December 31, 1976.

The interest charge on distributions to beneficiaries of foreign trusts is to apply to taxable years beginning after December 31, 1976. The provision applies to income from trusts whenever created. The change in the capital gains rule for foreign trusts not created by U.S. persons is to apply to taxable years beginning after December 31, 1975.

The amendment to the excise tax on certain transfers to foreign entities is to apply to transfers of property after October 2, 1975.

Revenue effect

It is estimated that these provisions will result in an increase in budget receipts of $2 million in fiscal year 1977 and of $10 million thereafter.

4. Amendments Affecting Tax Treatment of Controlled Foreign Corporations and Their Shareholders (secs. 1021 through 1025 of the bill and secs. 951, 954, 955, 956, 958, 963, and 1248 of the code)

Present law

Under present law, the United States imposes its income tax upon the worldwide income of any domestic corporation, whether this income is derived from sources within or from without the United States. A tax credit (subject to limits) is allowed for foreign income taxes imposed on its foreign source income.

Foreign corporations generally are taxed by the United States only to the extent they are engaged in business in the United States (and to some extent on other income derived here). As a result, the United States generally does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by a U.S. corporation or group of U.S. corporations (or by U.S. citizens or residents). Such a corporation is subject to tax, if at all, by the foreign country or countries in which it operates.

Generally, the foreign source income of a foreign corporation is subject to U.S. income taxes only when it is actually remitted to the U.S. corporate or individual shareholders as a dividend. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. The fact that no U.S. tax is imposed in this case until (and unless) the income is distributed to the U.S. shareholders (usually corporations) is what is generally referred to as tax deferral.[16]

Present law, however, provides for an exception to the general rule of deferral under the so-called subpart F provisions of the Code. Under these provisions income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend.

[16] Where it is not anticipated that the income will be brought back to the United States for financial accounting purposes (in accounting for the income of a consolidated group consisting of one or more domestic corporations and its foreign subsidiaries) this income in effect is often shown as income exempt from U.S. tax.

The rules generally apply to U.S. persons owning 10 percent or more of the voting power of a foreign corporation, if more than fifty percent of the voting power in the corporation is owned by U.S. persons owning 10 percent interests.

The categories of income subject to current taxation as tax haven income are foreign personal holding company income, sales income from property purchased from, or sold to, a related person if the property is manufactured and sold for use, consumption, or disposition outside the country of the corporation's incorporation, service income from services also performed outside the country of the corporation's incorporation, for or on behalf of any related persons, and shipping income (unless reinvested in shipping assets). The statute refers to these types of income as "foreign base company income." In addition, present law provides for the current taxation of the income derived by a controlled foreign corporation from the insurance of U.S. risks. Foreign base company income and income from the insurance of U.S. risks are collectively referred to as subpart F income.

Present law also provides, with certain exceptions, that earnings of controlled foreign corporations are to be taxed currently to U.S. shareholders if they are invested in U.S. property. In general terms, U.S. property is defined as all tangible and intangible property located in the United States.

In addition to denying deferral on certain categories of income under subpart F, present law treats as a repatriation of tax-deferred earnings the gain realized on the sale, exchange or redemption of stock in a controlled foreign corporation (sec. 1248). Present law provides that if a U.S. shareholder owns 10 percent or more of the total combined voting stock of a foreign corporation at any time during the 5-year period ending on the date of the sale or exchange (while the corporation was a controlled foreign corporation), the recognized gain is treated as a dividend to the extent of the foreign corporation's post-1962 earnings and profits attributable to the stock during the time it was held by the taxpayer and was a controlled foreign corporation. However, this provision does not apply to earnings and profits accumulated by a foreign corporation while it was a less-developed country corporation if the stock of that corporation was owned by the U.S. shareholders for at least 10 years before the date of the sale or exchange.

a. *Investment in U.S. property*

Reasons for change

As indicated above, present law treats an investment in U.S. property by a controlled foreign corporation as a taxable distribution to its U.S. shareholders. The reason why this provision was adopted was the belief that the use of untaxed earnings of a controlled foreign corporation to invest in U.S. property was "substantially the equivalent of a dividend" being paid to the U.S. shareholders. Therefore, it was concluded that this should be the occasion for the imposition of a tax on those earnings to the U.S. shareholders of the controlled foreign corporation making the U.S. investment. Present law is very broad as to the types of property which are to be classified as U.S. investments for purposes of this rule. For example, the acquisition by the foreign corporation of stock of a domestic corporation or obligations of a U.S. person (even though unrelated to the investor) is considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings to the investor's U.S. shareholders.

The committee believes that the present scope of the provision is too broad. In its present form it may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a controlled foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations. In the committee's view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax.

In the committee's view, since the investment by a controlled foreign corporation in the stock or debt obligations of a related U.S. person or its domestic affiliates makes funds available for use by the U.S. shareholders, it constitutes an effective repatriation of earnings which should be taxed. The classification of other investments in stock or debt of domestic corporations as the equivalent of dividends is, in the committee's view, detrimental to the promotion of investments in the United States. Accordingly, the committee's amendment provides that an investment in U.S. property does not result when the controlled foreign corporation invests in the stock or obligations of unrelated U.S. persons.

In addition, the committee believes that the inclusion of oil-drilling rigs used on the U.S. continental shelf acts as a disincentive to explore for oil in the United States. Since these rigs are movable, they can as easily be used in a foreign country. Accordingly, the committee's amendment excludes these rigs from the definition of U.S. property.

Explanation of provision

The committee's amendment adds three exceptions to the types of U.S. property the investment in which by a controlled foreign corporation results in taxation to its U.S. shareholders (see sec. 951(a)(1)(B)). It provides that the term "United States property" does not include stock or debt of a domestic corporation (unless the corporation is itself a U.S. shareholder of the controlled foreign corporation), if the United States shareholders of the controlled foreign corporation own or are considered to own, in the aggregate, less than 25 percent of the total combined voting power of all classes of stock of such domestic corporation which are entitled to vote. Thus, under this provision, a controlled foreign corporation cannot buy the stock of, or lend money to, any of its U.S. shareholders. In addition, a controlled foreign corporation cannot buy the stock of, or lend money to, U.S. corporations who are not U.S. shareholders of that controlled foreign corporation if those U.S. shareholders own 25 percent or more of the stock of the U.S. corporation. This 25 percent test is to be applied immediately after the investment by the controlled foreign corporation. In addition, the committee amendment provides that movable drilling rigs are not to be considered as U.S. property when used on the U.S. continental shelf.

The House bill also amended the definition of U.S. property, but in a more substantial way. Under the House bill, direct as well as portfolio investments in stock or debt obligations of unrelated U.S. persons would not constitute an investment in U.S. property. The committee believes there is a potential for abuse in the House approach.

In addition, the House changed the present rule that investments in tangible property located in the United States constitute investments in U.S. property. Under the House bill, investments in tangible property constituted investments in U.S. property when leased to or used by the U.S. shareholder or a person related to the U.S. shareholder even when used outside of the United States. The committee does not believe that this provision of the House bill is appropriate.

For purposes of determining who is a U.S. shareholder of a controlled foreign corporation, the constructive ownership rules apply (sec. 958(b)). However, the exception to those rules for certain persons other than U.S. persons (contained in sec. 958(b) (1) and (4)) do not apply. Thus, for example, stock owned by foreign persons is attributed to U.S. persons for purposes of determining whether U.S. shareholders of the controlled foreign corporation own 25 percent or more of a domestic corporation, the stock of which is acquired by the controlled foreign corporation, in determining whether there has been an investment in U.S. property. If at any time there is an investment in U.S. property, the U.S. shareholders of the controlled foreign corporation will be treated as having received a distribution under section 956 equal to the amount of the investment of the controlled foreign corporation. It is intended that if the facts indicate that the controlled foreign subsidiary facilitated a loan to, or borrowing by, a U.S. shareholder, the controlled foreign corporation is considered to have made a loan to (or acquired an obligation of) the U.S. shareholder.

The committee amendment also excludes from the definition of U.S. property movable drilling rigs (other than a vessel or aircraft) and other oil and gas exploration and exploitation equipment, including barges which are used for oil exploration and exploitation activities on the continental shelf of the United States. Basically, this exception includes that property which is entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere (sec. 48(a)(2)(B)(x)). For this purpose, the definition of continental shelf as used in section 638 is to be applied.

Effective dates

The amendments relating to investment in U.S. property by a controlled foreign corporation apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which, or with which, such taxable years of such foreign corporations end.

The committee's amendment permits taxpayers to elect to exclude certain investments from the definition of United States property. The election applies retroactively to all taxable years beginning before 1977 to which the provision defining the United States to include its continental shelf (sec. 638) applies. This election only applies to property situated on, or used exclusively in connection with, the continental shelf, or investments in stock or obligations of a domestic corporation, substantially all of the assets of which consist of such property. An election under this provision must be made within one year from the date of the enactment of this Act, and the election must be agreed to by every person who has at any time been a U.S. shareholder of the foreign corporation making the investment. If the assessment of any deficiencies in income tax resulting from the filing of this election for a taxable year ending before the date of the filing of the election is prevented before the expiration of one year after the date of the filing by reason of the statute of limitations or other law, the deficiency (to the extent attributable to the election) may be assessed at any time before the expiration of the one-year period notwithstanding any law or rule of law which would otherwise prevent the assessment.

For purposes of determining the increase in investment in U.S. property for years after 1975, the cumulative amount invested in U.S. property as of the close of the last taxable year of a corporation beginning before January 1, 1976, is computed under the amendments made by this section. Consequently, in determining the increase in earnings invested in U.S. property (under sec. 951(a)(1)(B)) in years beginning after December 31, 1975, only the investment in U.S. property as defined in your committee's bill as of the close of the last taxable year beginning before 1976 is considered.[17]

Revenue effect

It is estimated that this provision will have little or no effect on tax liabilities.

b. *Exception for investments in less-developed countries*

Reasons for change

As indicated above, present law contains an exception to the rules providing for dividend treatment on the sale of stock of a subsidiary which is classified as a less-developed country corporation. The extent to which this exception has provided an incentive to invest in less-developed countries is questionable. The size of the tax benefit to the U.S. investor depends on a variety of factors, such as the foreign tax rate in the country where the investment is made and in other countries, and the capital gains tax rate in the United States. Further, the relationship of the tax benefits to the investor to the benefits obtained by the developing country is erratic since the size of the tax benefit may bear no relationship to the amount of development capital invested. While these factors may occasionally combine to encourage investment in a certain less-developed country, the committee believes that it would be preferable to provide whatever assistance is appropriate to less-developed countries in a direct manner where the economic costs can be accurately measured.

Explanation of provision

The Committee's amendment repeals the less-developed country exception which excludes earnings accumulated while a corporation was

[17] For example, if for the last taxable year before this amendment applies a controlled foreign corporation is considered to have $100 invested in U.S. property under the law in effect prior to the amendment and $75 invested in U.S. property under the law as amended, $75 is the amount considered as invested in U.S. property for purposes of determining whether there has been an increase in investment in the following year.

a less-developed country corporation from those earnings and profits which are subject to tax as a dividend if there is gain from the sale or exchange of stock in the controlled foreign corporation (sec. 1248(d)(3) of the code). However, the exclusion is still applicable with respect to those earnings of a controlled foreign corporation which were accumulated during any taxable year beginning before January 1, 1976, while the corporation was a less-developed country corporation (as defined in sec. 902(d) as in effect prior to the enactment of this bill). The exclusion applies to pre-1976 earnings regardless of whether the U.S. shareholder owned the stock for ten years as of that date.

The House bill contains an identical provision.

Effective date

The amendment repealing the less-developed country exception under section 1248 applies to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this amendment will result in an increase in budget receipts of $11 million in fiscal year 1977 and of $10 million thereafter.

c. *Exclusion from subpart F of certain earnings of insurance companies*

Reasons for change

As indicated above, one of the principal categories of tax haven income subject to current taxation under present law is foreign personal holding company income (sec. 954(c)). This item of tax haven income consists of passive investment income such as dividends, interest, rents and royalties. Present law provides an exception for income of a foreign insurance company from its investment of unearned premiums or reserves which are ordinary and necessary for the proper conduct of its business.

In order to write insurance and accept reinsurance premiums, foreign insurance companies may be required by the laws of various jurisdictions in which they operate to meet various solvency requirements in addition to specified capital and legal reserve requirements. Many jurisdictions also employ an internal rule-of-thumb as to what the ratio of surplus to earned premiums should be. In the United States, the National Association of Insurance Commissioners employs a ratio of 1 to 3 (surplus to earned premiums) as the guideline by which State regulatory agencies can measure the adequate solvency of companies insuring casualty risks. If such a company's ratio were less than 1 to 3, for instance 1 to 4, the State regulatory agency may question its ability to accept additional risks. Surplus maintained in compliance with the 1 to 3 ratio, although not necessarily required by law, has been considered as ordinary and necessary to the proper conduct of a casualty insurance business in the United States.

Similar ratios often are employed in some foreign jurisdictions with respect to companies insuring casualty risks. Even where the foreign jurisdiction does not impose requirements as severe as those required in the United States, a foreign insurance company participating in a reinsurance pool composed principally of companies doing business in the United States must, for all practical purposes, maintain this ratio to satisfy the State insurance authorities involved. In these situations, the State regulatory agency, employing the relatively high ratio, will review the solvency of the foreign insurer before allowing the placement of the reinsurance policy with such foreign insurer. This effectively causes any foreign insurance company participating in a reinsurance pool to adhere to the high ratio. Those assets maintained by these insurance companies in order to meet this ratio test are necessarily in the form of investments, which, in turn, generate passive income such as dividend and interest income. Just as in the case of the maintenance and investment of unearned premiums or reserves, these insurance companies, in compliance with the high ratio requirement, must maintain and invest a certain portion of their assets in connection with the active conduct of their trade or business. The committee believes that it is appropriate to provide the same type of exception from subpart F for surplus which is required to be retained as is provided for unearned premiums or reserves.

Explanation of provision

The committee's amendment adds a new exception to the definition of foreign personal holding company income (sec. 954(c)(3)(C)). Under the exception, foreign personal holding company income does not include dividends, interest, and gains from the sale or exchange of stock or securities derived from investments made by an insurance company of an amount of assets equal to one-third of its premiums earned (as defined under sec. 832(b)(4)) during the taxable year on insurance contracts (other than for life insurance and annuity benefits under life insurance and annuity contracts, to which sec. 801 pertains).

The exception only applies to passive income received from a person other than a related person (as defined in sec. 954(d)(3)). Also, the exception only applies with respect to premiums which are not directly or indirectly attributable to the insurance or reinsurance of related persons. Where an insurance company participates in an insurance or reinsurance pool, it is not intended that the risk insured or reinsured by such company be treated as a risk of a related person merely because of the existence of the pooling arrangement, the existence of joint liability on the risk, or because a related insurance company may jointly share in the risk on a policy issued by one member of the pool.

An identical provision was in the House bill.

Effective date

The amendment applies to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporations end.

Revenue effect

It is estimated that this amendment will result in a decrease in budget receipts of $11 million in fiscal year 1977 and of $10 million per year thereafter.

d. *Shipping profits of foreign corporations*

Reasons for change

As indicated above, one of the categories of tax haven income subject to current taxation under the subpart F provisions of the Code is income derived from, or in connection with, the use of an aircraft or vessel in foreign commerce, except to the extent that the profits are reinvested in shipping assets. In general, base company income is defined for purposes of the tax haven provisions to mean income earned by a corporation outside the country of incorporation. In the case of base company shipping income, however, no distinction is made under present law for cases where a corporation derives its shipping income in the same country where it is incorporated. As in the case of other tax haven income, the committee believes that shipping activities should not be categorized as a base company activity when the corporation involved carries on its activities entirely in the country in which it is organized.

In addition, the committee believes that an exception to the tax haven provisions should be added in the case of a supply shipping operation between a point on shore and nearby offshore points. The committee also believes that an exception to the tax haven provisions should be added in the case of a foreign corporation if neither the corporation nor any related person owns any aircraft, vessel, or shipping facility, leases on a long-term charter any aircraft or vessel to another person for use in foreign commerce, or manufactures, produces, grows, or extracts any property shipped on an aircraft or vessel used (or hired or leased for use) by the corporation or by a related person.

The committee also is aware that present law is unclear as to what shipping profits are considered as reinvested in shipping assets and thus entitle a controlled foreign corporation to an exclusion from the subpart F provisions. The committee wants to insure that in any case where a controlled foreign corporation discharges an unsecured liability which constitutes a general claim against its shipping assets, the payment in discharge of that liability should be considered a payment toward the acquisition of a shipping asset as much as the payment on an obligation which constitutes a specific charge against a shipping asset.

Explanation of provision

The committee's amendment makes four changes in the base company shipping rules which were added to subpart F by the Tax Reduction Act of 1975. The amendment excludes three categories of shipping income from the base company shipping rules. The exclusion from base company shipping results in this income not falling into a different category of subpart F by being excluded from base company shipping income. The committee amendment broadens the exclusion in the House bill.

First, the amendment provides that base company income does not include shipping income derived from the operation of a vessel between two points in the country in which the vessel or airplane is registered and the corporation owning the vessel or airplane is incorporated.

Second, the amendment provides that base company income does not include shipping income derived from the transportation of men and supplies from a point in a foreign country to a point (such as an oil-drilling rig) located on the continental shelf of such country or on the continental shelf adjacent to the continental shelf of such country.

Third, the amendment provides that base company income does not include the shipping income of a foreign corporation if neither the corporation, nor any related person, owns any aircraft, vessel, or shipping facility, leases any aircraft or vessel to another person for use in foreign commerce under a long-term charter, or manufactures, produces, grows, or extracts any property (including natural resources and agricultural commodities) shipped on an aircraft or vessel used (or hired or leased for use) by the corporation or by a related person. The processing, sorting or preparation of goods for shipment does not constitute manufacturing of goods. For this purpose, the term "shipping facility" means property which is built, constructed, or installed particularly for use in shipping operations. Barges, cranes, and containers are examples of shipping facilities. Vessel stores and supplies, accounts receivable, and an office building are examples of assets which may be "qualified investments in foreign base company shipping operations" (sec. 955(b)) but which are not shipping facilities.

Fourth, the amendment clarifies the method of determining the amount of a controlled foreign corporation's qualified investments in shipping assets (sec. 955(b)(4)). The committee's amendment makes it clear that a liability evidenced by an open account or a liability secured only by the general credit of the corporation is taken into account in determining the amount of the corporation's qualified investments in shipping assets, to the extent that such a liability constitutes a claim against the corporation's shipping assets. As a result, payments made by the corporation in discharge of an unsecured liability are treated under the amendment as increasing qualified investments in shipping assets, to the extent that the unsecured liability constitutes a claim against the corporation's shipping assets.

Effective date

The changes made by the committee's amendment are applicable as of the date of the provisions which added the foreign-base company shipping rules and thus apply to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which or with which such taxable years of the foreign corporations end.

Revenue effect

It is estimated that this provision will decrease receipts by less than $5 million on an annual basis.

e. *Certain agricultural products*

Reasons for change

As indicated above, one of the categories of tax haven income subject to current taxation under the subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to the committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. The committee believes that sales of foreign-grown agricultural products for use, consumption, or disposition outside the United States should not be included within the definition of foreign base company sales income. The committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies could have difficulty competing with foreign-controlled companies. Accordingly, the committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.

Explanation of provision

The committee's amendment provides that for purposes of the tax haven foreign base company sales rules of subpart F, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption, or disposition outside the United States. The committee believes that this rule will be easier for the Internal Revenue Service to administer than either the rule contained in present law or the rule contained in the House bill.

Effective date

This section applies to taxable years of foreign corporations beginings after December 31, 1975, and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporation end.

Revenue effect

It is estimated that this provision will reduce budget receipts by $17 million in fiscal year 1977, $15 million in fiscal year 1978, and $15 million in fiscal year 1981.

5. Amendments to the Foreign Tax Credit (secs. 1031 to 1037 of the bill and secs. 78, 901, 902, 904, and 960 of the Code)

Present law

Present law permits taxpayers subject to U.S. tax on foreign source income to take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. The credit is provided only for the amount of income, war profits or excess profits taxes paid or accrued during the taxable year to any foreign country or to a possession of the United States.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result. Some countries avoid double taxation by exempting foreign source income from tax altogether. For U.S. taxpayers, however, the foreign tax credit system, providing a dollar-for-dollar credit against U.S. tax liability for income taxes paid to a foreign country, is the mechanism by which double taxation is avoided.

The foreign tax credit is allowed not only for taxes paid on income derived from operations in a specific country or possession of the

United States, but it is also allowed for dividends received from foreign corporations operating in foreign countries and paying foreign taxes. This latter credit, called the deemed-paid credit, is provided for dividends paid by foreign corporations to U.S. corporations which own at least 10 percent of the voting stock of the foreign corporation. Dividends to these U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

The computation of the amount of the foreign taxes allowed as a deemed-paid credit in the case of a dividend distribution differs depending upon whether or not the payor of the dividend is a less-developed country corporation. Initially, a question arose as to how much of the foreign taxes for purposes of this credit should be attributed to the earnings out of which dividends were paid and how much should be attributed to the portion of earnings used to pay the foreign taxes. This was decided in the Supreme Court case, *American Chicle Company*,[18] which required the foreign taxes paid for purposes of the credit to be allocated between the dividend distribution and the portion of the earnings used to pay the foreign taxes. The Congress in 1962, however, recognized that this resolution obtained less than the full U.S. tax on the dividend income because it omitted from the U.S. tax base the portion of the earnings used to pay the foreign tax. Where the foreign tax was less than the U.S. tax (but above zero), this gave an advantage to dividend income over income subject to the full United States tax. In 1962, the Congress corrected this problem for all corporations other than less-developed country corporations.

The correction made in 1962 took the form of requiring the earnings used to pay the foreign tax to be included in the deemed distribution base and then allowing the credit for foreign taxes paid to be based upon the earnings, including the amount paid as foreign taxes, and not merely the portion paid as a dividend.

These rules for the deemed-paid credit apply to distributions to a domestic corporation from a first-tier foreign corporation in which the domestic corporation is a 10-percent shareholder and to distributions from a second-tier or third-tier foreign corporation (through a first-tier foreign corporation). However, distributions originating from a foreign corporation that is more than three-tiers beyond the domestic corporate shareholder do not carry with it any deemed-paid foreign tax credit.

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his U.S. tax liability on his worldwide income is limited to his U.S. tax liability multiplied by a fraction the numerator of which is taxable income from sources outside the United States (after taking all relevant deductions) and the denominator of which is his worldwide taxable income. Under this limitation, the taxpayer thus aggregates his income and taxes from all foreign countries; a taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax which the United States would im-

[18] *American Chicle Company* v. *United States*, 316 U.S. 450 (1942).

pose on the taxpayer's income from all sources without the United States.

The alternative limitation is the per-country limitation. Under this limitation the same calculation made under the overall limitation is made on a country-by-country basis. The allowable credits from any single foreign country cannot exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's taxable income from that country and the denominator of which is worldwide taxable income. Taxpayers are required to use the per-country limitation unless they elect the overall limitation. Once the overall limitation is elected, it cannot be revoked except with the consent of the Secretary or his delegate.

The Tax Reduction Act of 1975 prohibits the limitation on the foreign tax credit on income from oil-related activities from being calculated under the per-country method. Instead, this income (and any losses) are computed under a separate overall limitation which applies only to oil-related income. Any losses from oil-related activity are to be "recaptured" in future years through a reduction in the amount of allowable foreign tax credits which can be used to offset subsequent foreign oil-related income.

In addition, the Tax Reduction Act of 1975 requires that the amount of any taxes paid to foreign governments which will be allowed as a tax credit on foreign oil extraction income is limited to 52.8 percent of that income (after deductions) in 1975, 50.4 percent in 1976, and 50 percent in subsequent years.

Finally, the Tax Reduction Act of 1975 also requires that no tax credit at all will be allowed with respect to payments to a foreign country in connection with the purchase and sale of oil or gas where the taxpayer has no economic interest in the oil or gas and the purchase or sale is at a price which differs from the fair market value.

In computing taxable income from any particular country or from all foreign countries for purposes of the fractions used in the tax credit limitations, all types of income are included as well as the deductions which relate to that income and a proportionate part of deductions unrelated to any specific item of income. Thus, for example, income from capital gains is included in the numerator and denominator of the limiting fraction as well as the deductions allocable to those gains (e.g., the 50-percent exclusion of capital gains for individuals). However, an exception is provided for interest income if that income is not derived from the conduct of a banking or financing business, or is not otherwise directly related to the active conduct of a trade or business in the foreign country. Such interest income and the taxes paid on it are subject to a separate per-country limitation to be calculated without regard to the other foreign income of the taxpayer.

In cases where the applicable limitation on foreign tax credits reduces the amount of tax which can be used by the taxpayer to offset U.S. tax liability in any one year, present law provides that the excess credits not used may be carried back for two years and carried forward for five years. However, if a person using the per-country limitation in any year elects subsequently to use the overall limitation, no carryovers are permitted from years in which the per-country limitation was used to years in which the overall limitation was elected.

The present foreign tax credit system, and in particular the present method of computing the alternative limitations on allowable foreign tax credits, contain a number of problems which result in inequities between taxpayers and which, in some cases, result in a reduction of U.S. tax on U.S. source income.

a. Per-country limitation and foreign losses

Reasons for change

The use of the per-country limitation often permits a U.S. taxpayer who has losses in a foreign country to obtain what is, in effect, a double tax benefit. Since the limitation is computed separately for each foreign country, losses in any foreign country do not have the effect of reducing the amount of credits allowed for foreign taxes paid in other foreign countries from which other income was derived. Instead, such losses reduce U.S. taxes on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax is based. In addition, when the business operations in the loss country become profitable in a subsequent tax year, a credit will be allowed for the taxes paid in that country. Thus, unless the foreign country in which the loss occurs has a tax rate no higher than the U.S. rate and has a net operating loss carryforward provision (or some similar method of using prior losses to reduce subsequent taxable income), the taxpayer receives a second tax benefit when income is derived from that foreign country because no U.S. tax is imposed on the income from that country (to the extent of foreign taxes paid on that income) even though earlier losses from that country have reduced U.S. tax liability on U.S. source income.

The committee does not believe that taxpayers should be permitted to obtain the double tax benefits described above. Accordingly, the committee believes that the per-country limitation should be repealed. In addition, where a taxpayer on the overall limitation reduces U.S. tax on domestic income by means of a loss from foreign sources, the committee believes that this tax benefit should be subject to recapture by the United States when foreign source income is subsequently derived. Comparable provisions are contained in the House bill.

Explanation of provisions

Per-country limitation.—The committee's amendment includes two provisions which prevent losses incurred from activities abroad from reducing U.S. tax on U.S. source income. The amendment repeals the per-country limitation. Taxpayers will be required to compute the limitation of the amount of foreign tax which can be used to reduce U.S. tax under the overall limitation. The effect of this provision is that losses from any foreign country will reduce income from other foreign countries for purposes of calculating the foreign tax credit limitation, and thus will reduce the amount of foreign taxes which can be used from those countries as a credit against U.S. tax. Foreign losses will reduce U.S. tax on U.S. income only in cases where foreign losses exceed income from all foreign countries for the taxable year. The bill also provides that the separate limitation for interest income which, under present law, is computed on a country-by-country basis, is to be computed on an overall basis.

It is the committee's understanding that the per-country limitation is not required under the provisions of any recent income tax treaty between a foreign country and the United States. It is the committee's intent that all existing treaties are to be applied consistently with this amendment by using the overall limitation in computing the allowable foreign tax credit.[19]

Because the provisions of this bill require taxpayers to compute their tax credit limitation on the overall method, special rules are included for taxpayers previously on the per-country limitation to permit some excess credits to be carried over from years in which the per-country limitation applied to years in which the overall limitation applies; similarly, special rules are provided to permit carrybacks from overall years to per-country years. The committee recognizes that the repeal of the per-country limitation may have a substantial adverse impact on the consolidated tax liability of an affiliated group. It is anticipated that in these cases the Internal Revenue Service will permit these companies to discontinue filing consolidated returns.

Carryovers from years beginning before January 1, 1976, during which the taxpayer was on the per-country limitation, to years beginning after December 31, 1975 (i.e., years during which the taxpayer is required to be on the overall limitation), are permitted if such carryovers were created under the rules of existing law (i.e., if, under the per-country limitation, the taxpayer had excess credits from one or more countries which could be carried forward). Under the committee amendment these excess credits are further limited in that they may be used only to the extent thev would be used had the per-country limitation continued to applv in the succeeding taxable years. This computation is to be made in the following steps. If the excess credits attributable to any specific country from prior years could have been used under the per-country limitation in the current year, the use of these credits in the current year is further restricted if the overall limitation produces a lower amount of total credits. If this limitation applies, the amount of the carryovers which may be used as credits are reduced to the amount allowed under the overall limitation. The amount of credits attributable to any country which are treated as being used in the current year is to be reduced by the amount of credits allowed under the per-country limitation that are not allowed under the overall limitation. This reduction in the credits to be available is allocated among the credits attributable to each of the foreign countries in the ratio of the credits allowable under the per-country limitation for each country to the aggregate of the credits allowable on this basis for all countries.[20] The remaining credits from each

[19] The committee further intends that, as is the case with other recent legislation modifying the foreign tax credit, the amendments made by the committee's bill are to be used in computing the credit allowed under all treaties.

[20] The following example illustrates this reduction. Assume company X has operations in countries A, B, and C as follows:

	A	B	C	Total
Income	40	60	−40	60
Taxes (current plus carried forward)	25	30	0	55

With a 50-percent U.S. tax rate, company X could use 50 credits under the per-country limitation (20 in A and 30 in B) and 30 under the overall. Thus the amount of the reduction is 20 (50 minus 30), and is allocated 8 to country A (20/50×20) and 12 to country B (30/50×20). In this case, 13 credits will be carried forward to subsequent years from country A (5 originally disallowed by the per-country limitation, plus 8 disallowed under the overall) and 12 credits will be carried forward from country B.

country which cannot be used in the current year can continue to be carried forward until the end of the 5-year carryforward period.

A slightly different rule is provided for foreign taxes which arise in taxable years beginning after December 31, 1975 (overall limitation years), which may be carried back to years beginning before January 1, 1976, during which the taxpayer was on the per-country limitation. First, the taxpayer is to determine if, under the normal rules applying to the overall limitation, any excess credits arise in the current year which are available to be carried back. If such excess credits do arise, the taxpayer is to make a country-by-country computation for the current year to determine what, if any, excess credits would arise from each country in that year under the per-country limitation. If excess credits arise from any country, those credits can be carried back. The credits which are available to be carried back for each country can then be applied to the appropriate earlier years if these excess credits could have been used in those years under the per-country limitation. Credits which are not available to be carried back may be carried forward to subsequent years under the 5-year carryforward rules.

Effective date

The repeal of the per-country provision and the related carryback and carryforward rules apply to taxable years beginning after December 31, 1975.

The committee is aware of the fact that certain existing mining ventures were begun with substantial investments of capital under the assumption that the foreign tax credit could be computed under the per-country limitation. The committee believes that it is appropriate to provide a limited transitional rule for these cases. The committee's amendment provides that in the case of a domestic corporation (whether or not it joins in the filing of a consolidated return with other corporations) which as of October 1, 1975, has satisfied four conditions, the per-country limitation may be used for all taxable years beginning before January 1, 1979. The four conditions are that the corporation has as of October 1, 1975: (1) been engaged in the active conduct of the mining of hard minerals (of a character for which a percentage depletion deduction is allowable (under sec. 613)) outside the United States or its possessions for less than 5 years; (2) has had losses from the mining activity in at least 2 of the 5 years; (3) derived 80 percent of its gross receipts since the date of its incorporation from the sale of the minerals that it mined, and (4) made commitments for substantial expansion of its mining activities.

A commitment for substantial expansion of mining activities means a commitment of additional capital for the purpose of substantially expanding mining production. For example, if the production of a mine for the period immediately before October 1, 1975, averaged less than 75 percent of designed capacity and if additional capital is required in order to increase production to reach designed capacity, the commitment of that additional capital, if substantial, would be a commitment for substantial expansion of mining activities. To the extent that any foreign loss was sustained on a per-country basis during the transition period the loss is to be subject to the general loss recapture on a per-country basis.

The committee is also aware that a similar problem exists with respect to certain ventures begun in Puerto Rico or other possessions.

Therefore, the committee's amendment applies the special transition period developed for mining ventures to existing ventures in Puerto Rico or other possessions. The House bill retained the per-country limitation in the case of income and losses from Puerto Rico and other possessions.

Loss recapture.—Repeal of the per-country limitation, as outlined above, will prevent a taxpayer who has foreign losses from reducing his U.S. tax on U.S. income if the taxpayer also has foreign income equal to or greater than the amount of losses. However, in a case where an overall foreign loss exceeds foreign income in a given year, the excess of the losses can still reduce U.S. tax on domestic source income. In this case, if the taxpayer later receives income from abroad on which he obtained a foreign tax credit, the taxpayer receives the tax benefit of having reduced his U.S. income for the loss year while not paying a U.S. tax for the later profitable year. To reduce the advantage to these taxpayers, the committee has included a provision which requires that in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses should, in effect, be recaptured by the United States when the company subsequently derives income from abroad.

In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources. The amount of the foreign income which is to be treated as income from domestic sources in a subsequent year is limited to the lesser of the amount of the loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for that year, or such larger percent as the taxpayer may choose. Thus, in any taxable year the amount subject to recapture is not to exceed 50 percent of the taxpayer's foreign income (before recharacterization) unless the taxpayer chooses to have a greater percentage of his foreign income so recharacterized. Since the amount that is recaptured represents a loss which in the previous taxable year reduced the U.S. tax on income from U.S. sources, the recaptured amount is to be treated as income from sources within the United States.

For the purposes of this recapture provision the committee's amendment defines the term "foreign loss" to mean the amount by which the gross income from sources without the United States is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to foreign sources and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under sec. 862(b) of the Code). However, in computing the amount of the foreign loss, the net operating loss deduction (under sec. 172(a)) and any capital loss carryback and carryover to that year (under sec. 1212 of the Code) are not to be taken into account. In addition, foreign expropriation losses (as defined in sec. 172(k)(1) of the Code) or a loss which arises from fire, storm, shipwreck, or other casualty, or from theft (unless the loss is compensated for by insurance or otherwise) are not subject to the recapture provision. A taxpayer is to be treated as sustaining a foreign loss whether or not he claims a foreign tax credit for the year of the loss.

The committee's amendment also provides for the recapture of a loss where property which was used in a trade or business, and which is used predominantly outside of the United States, is disposed of prior to the time the loss has been recaptured under the rules discussed above. These rules are to apply regardless of whether gain is otherwise recognized. In cases where gain would otherwise not be recognized, the taxpayer is to be treated as having received gain which is to be recognized in the year the taxpayer disposes of the property. The gain is to be the excess of the fair market value of the property disposed of over the taxpayer's adjusted basis in the property. Of course, the gain to be recognized under this provision is to be limited to the amount of the foreign losses not yet recaptured. In the case of a recapture resulting from the disposition of the property, 100 percent of the gain (to the extent of losses not previously recaptured) is recaptured. In such a case the 50-percent of gain limit is not applied and the amount (if any) to be recaptured in future years is reduced by the full amount of the gain.

For purposes of the recapture provisions, the term "disposition" includes a sale, exchange, distribution, or gift of property whether or not gain or loss would otherwise be recognized.

If income is recognized solely because of this disposition rule, such income receives the same characterization that it would been given had the taxpayer actually sold or exchanged the property. In such cases, the Secretary of the Treasury is given the authority to prescribe appropriate regulations to provide for any necessary adjustments to the basis of the property to reflect any taxable income so recognized. However, a disposition for this purpose only includes a transfer of property which is a material factor in the realization of taxable income by the taxpayer. A disposition for this purpose does not include a transfer of property to a domestic corporation in a distribution or transfer which has carryover attributes (sec. 381(a)). Property is to be treated as a material factor in the realization of income not only if it is or was a material factor in the production of income, but also if it would be in the future.

In determining whether the predominant use of any property has been without the United States, the use of the asset during the 3 years immediately prior to the disposition (or during the entire period of use of the property, if less) is to be taken into account.

Effective date

The loss recapture provisions apply to losses sustained in taxable years beginning after December 31, 1975, with two exceptions. The first exception applies to loss from a debt obligation of a foreign government. In the case of a loss from the disposition of a bond, note, or other evidence of indebtedness issued before May 14, 1976, by a foreign government or instrumentality thereof for property located in that country or stock or indebtedness of a corporation incorporated in such country, the loss recapture provision does not apply. This provision is intended to provide relief where foreign subsidiaries of domestic corporations incur losses because they were forced, under the threat of expropriation, to exchange their stock or assets for long-term debt obligations of a foreign government which yield very low interest.

The second exception applies to cases where the loss although sustained in a year after the effective date is from stock or indebtedness (including guarantees) of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

The termination may be by reason of sale, liquidation or abandonment of a single corporation or a group of corporations which are operated in the same line of business. To take into account more than one corporation in computing the 5-year tests, all these corporations must terminate their operations by January 1, 1977.

This exception applies where a corporation has suffered an operating loss in three out of the five years preceding the year in which the loss was sustained, has sustained an overall loss for those five years, and the termination takes place before January 1, 1977.

Revenue effect

It is estimated that the repeal of the per-country limitation will result in an increase in budget receipts of $41 million in fiscal year 1977, $35 million in fiscal year 1978 and $50 million in fiscal year 1981.

It is estimated that the loss recapture provisions will result in an increase in budget receipts of $2 million in fiscal year 1977, $8 million in fiscal year 1978 and $28 million in fiscal year 1981.

b. Dividends from less-developed country corporations

Present law

Under present law, the amount of dividend from a less-developed country corporation included in income by the recipient domestic corporation is not increased (i.e., grossed up) by the amount of taxes which the domestic corporation receiving the dividend is deemed to have paid to the foreign government. Instead the amount of taxes is reduced by the ratio of the foreign taxes paid by the less-developed country corporation to its pretax profits.

Reasons for change

The failure to gross-up the dividend by the amount of the foreign taxes that are deemed paid results, in effect, in a double allowance for foreign taxes. The problem arises from the fact that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax). The result is that the combined foreign and U.S. tax paid by the domestic corporation is less than 48 percent of the taxpayer's income in cases where the foreign tax rate of the less-developed country corporation is lower than the 48 percent U.S. corporate tax rate (but above zero).[21] In cases where the for-

[21] For example, assume that a foreign country imposes a 30-percent tax on $1.000 of income. If the foreign corporation earns $1.000 as a less-developed country corporation in that country, a distribution by that corporation of the remaining $700 to its U.S. parent corporation would result in $700 income to the U.S. parent. The parent's U.S. tax would be $336 before allowance of a foreign tax credit. In calculating the foreign tax credit, the $300 amount of foreign taxes paid would be reduced by 300/1000 to $210. The $210 could then be credited against U.S. tax liability of $336, leaving a net liability of $126. Thus, the combined U.S. tax and foreign tax liability on the original $1.000 of income would be $426 ($300 foreign taxes plus $126 U.S. tax), not the $480 which should be paid at a 48 percent rate.

If that same foreign corporation earning $1.000 were not a less-developed country corporation, the entire 1.000 would be included in the parent corporation's income if it received a dividend of $700 which would carry with it foreign taxes of $300. In this case, the U.S. tax before credit would be $480. The entire $300 of foreign taxes would be credited, leaving a U.S. tax liability of $180. The combined U.S. tax and foreign tax liabilities would be $480.

eign tax rate exceeds 48 percent, the dividend does not bring with it all the foreign taxes that were paid and thus the size of foreign tax credit carryover is reduced.

The size of the tax differential which exists in the case of dividends from less-developed country corporations varies with the foreign tax rate, as can be seen by the table below:

TABLE 1.—RATE DIFFERENTIAL ENJOYED WITH RESPECT TO DIVIDENDS FROM LESS-DEVELOPED COUNTRY CORPORATIONS WITH VARIOUS SELECTED FOREIGN INCOME TAX RATES AND PRESENT 48 PERCENT U.S. RATE

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential enjoyed by foreign subsidiary (percent)
$100	0	$100	$48.00	0	$48.00	$48.00	0
$100	$10	90	43.10	$9.00	34.20	44.20	3.90
$100	20	80	38.40	16.00	22.40	42.40	5.60
$100	24	76	36.48	18.24	18.24	42.24	5.76
$100	30	70	33.60	21.00	12.60	42.60	5.40
$100	40	60	28.80	24.00	4.80	44.80	3.20
$100	48	52	24.96	24.96	0	48.00	0
$100	55	45	21.50	24.75	[1] 0	55.00	0

[1] Excess credits of 3.25 are generated.

Further, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when there is no foreign tax imposed at all. The maximum tax differential, given a 48-percent U.S. tax rate, occurs when the foreign tax is half that, or 24 percent. The differential at this point is 5.76 percentage points.

Your committee believes that in the interest of uniform tax treatment between developed and less-developed country corporations and among all less-developed country corporations, this double allowance should be removed. Further, providing for identical treatment between all foreign corporations will simplify the foreign tax credit computation.

Explanation of provision

Under the committee's amendment, dividends from less-developed country corporations are treated the same as dividends from other foreign corporations. Thus, the amount of the dividends is increased by the amount of taxes deemed paid with respect to that dividend.

The committee amendment is identical to the amendments in the House bill.

Effective date

For distributions out of current income, the amendment is effective for taxable years beginning after December 31, 1975. However, the bill provides that for corporations making distributions in taxable years beginning after December 31, 1975, and received by a domestic corporation before January 1, 1978, the provisions of this bill apply to such distributions only to the extent that the distributions are made out of accumulated profits of the foreign corporation for a taxable year (of such foreign corporation) beginning after December 31, 1975. Thus, during that period, distributions of a less-developed country corporation out of earnings and profits accumulated in taxable years beginning before January 1, 1976, are taxed as under present law. After January 1, 1978, however, the provisions of this bill apply to all distributions regardless of the year in which the earnings are accumulated.

Revenue effect

It is estimated that this provision will increase budget receipts by $64 million in fiscal year 1977 and by $55 million thereafter.

c. *Treatment of capital gains*

Reasons for change

The present foreign tax credit limitation creates a number of problems in the treatment of capital gains stemming from the fact that capital gains are taxed differently than ordinary income. In many cases the source of income derived from the sale or exchange of an asset is determined by the location of the asset, or, if the asset is personal property, by the place of sale (i.e., the place where title to the property passes). In the latter case, taxpayers presently can often exercise a choice of the country from which the income from the sale of personal property is to be derived. It has thus been possible, in some cases, for a taxpayer to plan sales of personal property (including stocks or securities) in such a way as to maximize his use of foreign tax credits within the per-country or overall limitation by arranging that the sale of that property take place in a certain country.

Since most foreign countries (including the United States) impose little, if any, tax on sales of personal property by foreigners if the sales are not connected with a trade or business in that country, the present system permits taxpayers to plan sales of their assets in such a way so that the income from the sale results in little or no additional foreign taxes and yet the amount of foreign taxes they can use as a credit against their U.S. tax liability is increased.

Further problems in the treatment of income from the sale or exchange of assets for purposes of the foreign tax credit limitation are presented because present law includes no explicit rules for netting long-term and short-term gains and losses in cases where some gains or losses are U.S. source income while other gains or losses are foreign source income. The Internal Revenue Service has held that if a taxpayer (in certain circumstances) has losses from sources within the United States and has gains from sources outside the United States, the domestic losses do not offset the foreign gains for purposes of determining taxable income from sources without the United States in the limiting fraction of the per-country or overall limitation on foreign tax credits. For example, if a taxpayer has long-term gain from sources outside the United States, that gain will increase income from sources without the United States and thus will increase the amount of foreign tax credits allowed to reduce U.S. tax liability, even though that gain has no effect on the taxpayer's pre-credit U.S. tax liability because it is offset by U.S. source capital losses. The result is that in a case of foreign gains and domestic losses the amount of foreign tax credits which can be used is increased without a commensurate increase in U.S. tax liability; U.S. tax on U.S. income is reduced.

A final problem with the treatment of capital gains under the foreign tax credit system is presented by the fact that the credit limitations are not adjusted to reflect the lower tax rate on capital gains income received by corporations.[22] Under present law, corporations having a net long-term capital gain in most instances pay only a 30-percent rate of tax on that gain. But for purposes of determining foreign source and worldwide income in the limiting fraction of the foreign tax credit limitation, income from long-term capital gain is treated the same as ordinary income (i.e., as if it were subject to a 48-percent rate of tax).[23] Similarly, a taxpayer who has a capital gain income from U.S. sources and has foreign source income that is not capital gain does not receive a full credit for the amount of U.S. tax attributable to foreign source income.[24]

The committee believes that adjustments should be made to the foreign tax credit limitation to take into account the fact that capital gains are taxed differently from ordinary income.

Explanation of provisions

The committee's amendment includes three provisions altering the treatment of income from the sale of capital assets for purposes of computing the limitation on the foreign tax credit. The amendment establishes specific rules for determining the extent to which income from the sale or exchange of capital assets from sources outside the United States is to be included in the limiting fraction in calculating the foreign tax credit limitation.

The amount of capital gain included in foreign source income is referred to as "foreign source capital gain net income", defined as the lower of capital gain net income from sources without the United States or capital gain net income. (Capital gain net income is the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.) Thus, under this provision, foreign capital gain can be used to increase the amount of tax credits available to offset U.S. tax liability only to the extent the foreign capital gain results in a foreign source capital gain net income. In cases where foreign and net U.S. losses equal or exceed foreign gains, the foreign gains will not be taken into account for purposes of determining the limitation.

The second adjustment for capital gains income of corporations under the foreign tax credit limitation provides that the foreign source capital gain net income taken into account is to be reduced by three-eighths of foreign source net capital gain. Foreign source net capital gain is defined as the lower of the net capital gain from sources without the United States or net capital gain. (Net capital gain is the excess of long-term capital gain over short-term capital loss.)

[22] A similar problem exists to a much lesser extent for capital gains income of individuals under the alternative tax (secs. 1201 (b) and (c)). However, since only a limited amount of income is eligible for this treatment it was felt unnecessary to deal fully with this problem.

[23] For example, if a corporation has worldwide income of $20 million, $10 million of which is ordinary income from sources within the United States and $10 million of which is income from the sale of an asset from sources without the United States, that corporation is allowed a foreign tax credit equal to one-half (10/20) of his U.S. tax liability, even though only $3 million of the $7.8 million in U.S. tax liability is attributable to foreign source income. Present law thus favors the taxpayer with foreign source capital gain since his U.S. tax on U.S. ordinary income of $10 million is not treated as being $4.8 million but as $3.9 million.

[24] For example, if such a taxpayer had $10 million of U.S. source capital gain and $10 million of foreign ordinary income, the foreign tax credit limitation would limit the credit to $3.9 million even though he would be liable for $4.8 million of U.S. tax on his foreign source income.

In effect a maximum 30/48ths of the net long-term capital gain from sources without the United States is taken into account.[25]

This reduction of income is made to prevent distortion in the amount of foreign tax credits allocable to foreign income, which can result because capital gains for corporations is taxed at a 30-percent rate rather than a 48-percent rate.[26]

The committee's amendment also provides a special rule which applies to personal property sold outside of the United States by a corporation or by an individual (if sold or exchanged outside of the country of the individual's residence). In these cases, no income is included for purposes of calculating the numerator of the foreign tax credit limitation from such sales or exchanges if the country in which such property is sold does not impose an income, war profits, or excess profits tax at a rate at least equal to 10 percent of the gain from the sale or exchange as computed under U.S. tax rules. This is accomplished by treating the foreign source capital gain as U.S. source income. The purpose of this rule is to prevent taxpayers from selling their assets abroad primarily to utilize any excess foreign tax credits which they may have available from other activities. It was concluded that if the foreign government significantly taxes a sale, that sale probably did not take place in that country purely for tax purposes. The committee concluded that a tax of 10 percent of the gain was substantial for these purposes.

The rules treating foreign source capital gain as U.S. source income do not apply in three situations, even though no foreign tax is paid on the gain. These cases involve situations where the sale is not made in a country purely for tax purposes and, thus, an exception to the general rule should be made. The three cases are: First, in the case of a sale by an individual, if the property is sold or exchanged within the individual's country of residence. Second, in the case of a sale by a corporation of stock in a second corporation, if the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income for the 3-year period ending with the close of the second corporation's taxable year immediately preceding the year during which the sale took place. Third, in the case of a sale by a corporation or an individual of personal property (other than stock in a corporation), if the property is sold in a country in which such property was used in a trade or business of the taxpayer or in which the taxpayer derived more than 50 percent of its gross income for the 3-year period ending with the close of its taxable year immediately preceding the year during which the sale took place.

The changes in capital gains income generally are to apply both to capital assets and to business assets if such assets are treated as

[25] If a corporation has, for example, $100 of net long-term capital gain from sources without the United States, all of which is foreign source capital gain net income, that corporation includes as foreign source income only a maximum of 30/48ths (or ⅝) thereof. Assuming that all of the corporation's foreign source capital gain net income qualifies as foreign source net capital gain, the corporation is permitted only $30 in tax credits attributable to the $100 of foreign source income, rather than the $48 in foreign tax credits which would be permitted without the reduction in capital gain income. Similarly, a company which has $100 in domestic capital gain income and $100 in foreign source ordinary income includes as U.S.-source income 30/48ths of its U.S. source net capital gain. Such a corporation has a $48 limitation on foreign tax credits attributable to the $100 of foreign income rather than $39 as would be permitted without the reduction in capital gains income.

[26] A similar adjustment is not needed in the case of taxpayers other than corporations (even though the alternative tax might be used) since in computing taxable income for purposes of the foreign tax credit limitation a deduction is taken for long-term capital gains (sec. 1202).

capital assets under the applicable code provision. The new rules for capital gains are to be applied before application of the rules dealing with the recapture of foreign losses.

A similar provision was in the House bill; however, the committee amendment makes various technical amendments.

Effective dates

These amendments are to take effect begining with taxable years beginning after December 31, 1975, except that the third rule which treats foreign source gain as U.S. source gain only applies to sales or exchanges made after November 12, 1975.

Revenue effect

It is estimated that the capital gain provisions will result in an increase in budget receipts of $11 million in fiscal year 1977 and $10 million thereafter.

d. Foreign oil and gas extraction income

(1) Transitional rule for foreign taxes on oil and gas extraction income

Reasons for change

As indicated above, present law contains a limitation on the amount of foreign taxes with respect to foreign oil and gas extraction income which is allowable as a credit. The limitation on the foreign tax credit is stated as a percentage of the foreign oil and gas extraction income. The percentage is 52.8 percent in 1975, 50.4 percent in 1976, and 50 percent in 1977. Foreign taxes in excess of the limitation are neither allowable as a credit in that year or in any other taxable year. While the committee generally believes that taxes in excess of the limitation should not be allowed as a credit in any other taxable year, the committee's attention has been called to certain situations where during the transition period distortions in the computation of the limitation on the credit for foreign oil and gas extraction income could arise due to the difference in computing taxable income used by the United States and the foreign taxing country. Where a foreign country during this transition period imposes taxes lower than the U.S. rate in one year and imposes taxes higher than the U.S. rate in a later year, the committee believes it is appropriate to extend in this limited situation a foreign tax credit carryback against extraction income in the same country.

Explanation of provision

The committee amendment provides a special carryback during the transition period to any taxable year ending in 1975, 1976 or 1977. This carryback is to be computed by using the normal foreign tax credit carryback rules (sec. 904(c)). Thus, a carryback is to be allowed only to the two preceding taxable years from which the tax is carried. Second, the extraction taxes which may be carried back may only be carried back against extraction income in the same country to which the extraction taxes were paid.

The amount which may be carried back to any taxable year is limited to the net U.S. tax liability on the extraction income from that country for a year after taking into account the foreign tax credit. Thus, the amount allowed as a carryback may not exceed an amount equal to the amount of the foreign oil and gas extraction income for the year multiplied by the sum of the normal tax and surtax rates for the year, less the amount of any creditable taxes which are paid or accrued with respect to the foreign oil and gas extraction income against which the credits are to be offset.[27] The amount carried back is to be deemed tax paid or accrued on income from the extraction of foreign oil and gas in the year to which carried. For purposes of this provision, extraction taxes which may be carried back are the income taxes paid or accrued during a year with respect to foreign oil and gas extraction income which would be allowed as a foreign tax credit but for the special percentage limitations on foreign oil and gas extraction income.

The committee amendment while similar to the House bill contains a rule not found in the House bill, that the amount carried back is to include any amount in connection with production-sharing contracts which is treated as a tax but which exceeds the amount allowed as a credit for any taxable year under the committee's special rule for production-sharing contracts (see discussion below).

Effective date

This provision is effective for taxable years ending after December 31, 1974.

Revenue effect

It is estimated that this provision will reduce budget receipts by $8 million in fiscal year 1977 and $10 million in fiscal year 1978.

(2) Transitional rule for recapture of foreign oil-related losses

Reason for change

As indicated above, the Tax Reduction Act of 1975 required that the foreign tax credit on foreign oil-related income be computed under a separate overall limitation and that any oil related losses sustained in taxable years ending after December 31, 1975, be recaptured in future years through a reduction in the amount of foreign taxes allowed to offset United States tax on foreign oil-related income. This is accomplished by treating such losses as U.S. source income.

The amount of loss recaptured in any year is the lesser of all prior oil-related losses not yet recaptured or 50 percent of the foreign oil-related income. The committee believes that some transitional rules should have been included for the recapture rule in view of the substantial investments required to develop new oil or gas properties pursuant to contracts entered into prior to the enactment of the Tax Re-

[27] The carryback permitted under this provision may be illustrated by the following example: Assume in 1977 a taxpayer derives $100 of foreign oil and gas extraction income on which he pays $80 of foreign taxes which, but for the provisions of section 907, would be allowable as a foreign tax credit. Thus, in 1977, under the provisions of section 907, the taxpayer would be allowed a $50 foreign tax credit (the other $30 being disallowed). Under the special transition rule the disallowed $30 of foreign taxes would, subject to the conditions of this provision, be eligible for a 2-year carryback to 1975 and then 1976. Assume further that the taxpayer had no extraction income in 1975, and that in 1976 the taxpayer derived $150 of foreign oil and gas extraction income on which he paid $20 of foreign taxes which were allowable as a foreign tax credit for the taxable year. The taxpayer's U.S. tax liability would be 48 percent of $150, which is $72, against which the taxpayer would have taken a $20 foreign tax credit and had a net liability for U.S. taxes of $52. Under this provision, the taxpayer would be entitled to carry the $30 of disallowed taxes from 1977 back to 1976 and claim these taxes as a foreign tax credit, thus making $50 of foreign taxes allowable as a credit for that year, resulting in net U.S. tax liability of $22. If, in addition, the taxpayer had an additional $30 in 1978 which was disallowed as a foreign tax credit by reason of section 907, only $22 ($72 minus ($20+$30)) would be allowed as a carryback to 1976.

duction Act of 1975. Generally, it takes 3 to 5 years to develop such properties before significant commercial production comes on stream. Substantial investments were, therefore, made with anticipation of losses but without taking into account the recapture of such losses. While the committee generally believes such losses should be subject to recapture, it would be inequitable to subject these losses to the full rate of recapture.

Explanation of provision

The committee's amendment provides that a taxpayer may recapture certain foreign oil-related losses over a longer period than under present law. The longer period applies only to a foreign oil-related loss which is sustained in a taxable year ending before January 1, 1979, and which was incurred pursuant to a binding contract to explore or to develop oil or gas property entered into on or before July 1, 1974. Under this provision, not more than 15 percent of the loss is recaptured for each of the first four taxable years beginning with the first year for which a foreign tax credit is claimed on foreign oil-extraction income. Thereafter, any remaining loss is recaptured in accordance with present rules. No comparable provision is contained in the House bill.

Effective date

This provision is effective for taxable years ending after December 31, 1974 (the effective date of the foreign oil recapture rules in the Tax Reduction Act of 1975).

Revenue effect

It is estimated that this provision will reduce budget receipts by $21 million in fiscal year 1977 and $6 million in fiscal year 1978. However, the reduction in those years will be recaptured by increased receipts in the following years.

(*3*) *Definition of foreign oil-related income*

Reasons for change

As indicated above, the Tax Reduction Act of 1975 required that the foreign tax credit for foreign oil-related income be comnuted under a separate overall limitation. In addition, the amount of the foreign tax credit for taxes paid with respect to "foreign oil and gas extraction income" is limited to a percentage of such income. Generally, "oil and gas extraction income" means taxable income from the extraction of oil and gas and from the sale of assets used in such extraction activities. Generally, "foreign oil-related income" means taxable income from the extraction of oil and gas, the processing of oil and gas into their primary products, the transportation and distribution or sale of oil, gas, and primary products, and the sale of assets used in such activities.

In addition, both foreign oil and gas extraction income and foreign oil-related income include dividends from a foreign corporation if foreign taxes paid by it, whether or not there are taxes, would be treated as paid by the taxpayer. Interest from such a foreign corporation is included only in foreign oil-related income. In each case, only the portion attributable to foreign oil and gas extraction income or foreign oil-related income, as the case may be, is taken into account.

These amounts were included in order to avoid discriminating between taxpayers who carried on foreign oil-related activities through branches of domestic corporations and those who operated through foreign subsidiaries. For a similar reason, foreign oil-related income includes an allocable portion of dividends from a domestic corporation if such dividends are treated as foreign source income by reason of the fact that less than 20 percent of such corporation's gross income is derived from U.S. sources. However, interest from a domestic corporation is likewise treated as foreign source income if less than 20 percent of its gross income is from U.S. sources. Therefore, the committee believes that interest and dividends from domestic corporations should be treated the same.

Also, it has been called to the attention of the committee that the definition of foreign oil-related income includes certain unintended items. In most cases, processing, transportation, and distribution activities are carried on by members of affiliated corporate groups which are also engaged in substantial extraction activities. For this reason, income from these related activities is made subject to the same separate overall limitation. However, regulated public utilities in foreign countries often construct their own pipelines to the source of natural gas so as to be able to transport gas to their own generating or distribution facility located in that country. Under present law, income attributable to these transportation and distribution activities is classified as foreign oil related income even though the utility is not engaged in the extraction of the gas from a foreign country and is not subject to a foreign tax on extraction income. Further, some utilities have found it useful in their operations to explore for gas to be used within their own systems. In either event, the committee believes that the distribution or transportation of gas by a public utility through its own system should not be subject to the special limitation for oil-related income.

Explanation of provisions

(*a*) *Interest income*

The committee's amendment revises the definition of foreign oil-related income to include interest from a domestic corporation provided the interest is treated as foreign source income by reason of the fact that less than 20 percent of such corporation's gross income is derived from sources within the United States. As in the case of dividends included under present law, only the portion of the interest attributable to foreign oil-related income is included. The apportionment standards for foreign source income (sec. 862(b)) are to be used in making the allocation. Interest, like dividends, from a domestic corporation is not included in foreign oil and gas extraction income. No comparable provision is in the House bill.

Effective date

This provision of the committee amendment is to apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that the inclusion of interest in oil-related income will result in a decrease in budget receipts of $40 million in fiscal year 1977 and of $90 million thereafter.

Explanation of provision

(*b*) *Public utility income*

In addition, the committee's amendment revises the definition of foreign oil-related income so that it does not include income from the transportation or distribution of natural gas by a regulated public utility for use within its own regulated public utility operations within the country in which it is incorporated and in which the regulated public utility is located. Where a utility obtains part of its supplies of natural gas from its own extractions activities, any allocation of income between its extraction and its transmission and distribution activities is to take into account the fact that the utilities activities are regulated and that it may not be able to charge as much for gas as the wellhead as it could on the open market. No comparable provision is in the House bill.

Effective date

This provision applies for taxable years beginning after December 31, 1974.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

(*c*) *Sale of stock in foreign corporations filing consolidated returns*

Explanation of provision

The committee's amendment clarifies the definition of foreign oil-related income and foreign oil and gas extraction income in the case of the sale of stock of a foreign corporation entitled to be included as a member of a consolidated group. Since the income from such a corporation is included in the consolidated group for purposes of determining whether the income is foreign oil-related or foreign oil and gas extraction income, the sale of the stock is to receive the same identical treatment, to the extent the assets of the company whose stock is sold were used for the production of either foreign oil-related income or foreign oil and gas extraction income.

Effective date

This provision applies for taxable years beginning after December 31, 1974.

Revenue effect

It is estimated that this provision will result in a decrease in tax liability of less than $5 million annually.

(*4*) *Foreign oil-related income earned by individuals*

Reasons for change

As indicated above, the foreign tax credit that can be claimed for foreign oil and gas extraction income is limited by a percentage of that income, and the amount of U.S. taxes that can be offset by these taxes in any year is subject to a separate overall limitation based on foreign oil-related income.

Foreign oil-related income includes (in addition of extraction income) income from processing, transportation, and distribution activities. These items are not included in foreign oil and gas extraction income. Individuals and corporations are subject to the same percentage limitation under present law. However, the committee believes that individuals seldom have foreign oil-related income which is not also included in foreign oil and gas extraction income. In addition, limiting the amount of creditable taxes to the corporate rate is unfair or unduly generous in the case of certain individuals. For example, if an individual has a high effective rate of tax (in excess of the corporate rate), his disallowed foreign tax credit will cause him to pay U.S. tax on his foreign extraction income, while a corporation would owe no U.S. tax.

Explanation of provision

The committee amendment provides that the allowable foreign tax credit on foreign oil and gas extraction income is to equal the average U.S. effective rate of tax on that income. Thus, in any case there will be sufficient tax credits to offset the U.S. tax on the foreign oil and gas extraction income but no excess credits to offset U.S. tax on other foreign source income. The committee amendment achieves this result by limiting the taxpayer to a separate overall foreign tax credit limitation for foreign oil and gas extraction income. No comparable provision is in the House bill.

Effective date

This provision is effective for taxable years ending after December 31, 1974.

Revenue effect

It is estimated that this provision will decrease revenues by less than $5 million on an annual basis.

(*5*) *Oil payments not considered as taxes where no economic interest*

Reasons for change

As indicated above, the Tax Reduction Act of 1975 provided that no foreign tax credit is allowable for payments to a foreign country in connection with the purchase and sale of oil or gas where the taxpayer has no economic interest in the oil or gas and the purchase or sale is at a price which differs from the fair market value of the oil or gas. This provision was intended to deny any foreign tax credit to oil companies with respect to oil or gas which is owned by the foreign government (i.e., oil which is described as nonequity oil or buyback oil) where payments for the purchase of oil owned by the foreign country are disguised as the payment of a tax by casting normal crude purchase and sale arrangements in non-commercial formats. If oil was purchased from an affiliate at less than the market price and resold at a price equal to or higher than the market price, the difference between the purchase and sale price may be taxed by the foreign government so that the net economic result is the same, for the foreign government, as a simple purchase of the oil. Further, a foreign government could require the oil to be purchased from the government at less than the fair market price and resold at greater than the fair market price. By creating an artificial profit, a "tax" could be imposed for which a foreign tax credit could be claimed.

It was expected that this potential abuse would become increasingly prevalent as foreign governments take over oil companies' interests in concessions. Under these circumstances all oil and gas extracted from foreign concessions could be subject to a tax on the purchase and sale.

The committee's attention has been called to the difficulties which arise in the case of oil companies which made substantial investments before the Tax Reduction Act of 1975 in oil or gas fields under concessions which have been or will be taken over by the foreign government. In some cases, these changed relationships involve or will involve the private companies having rights to buy, at a discount, oil or gas produced from the areas to which their previous rights related. In certain cases it may not be clear whether all the taxes paid on the income resulting from the discount are creditable even though the discount was granted in connection with the government's takeover of the company's previous rights. In some cases the foreign government may choose to compensate the oil company for the value of its prior investments with a flat amount or a per barrel fee. In other cases, the foreign government may prefer to allow the oil company to purchase oil or gas from that field at a discount per unit of production. It is not clear whether the oil company would be treated as continuing to have an economic interest in the oil or gas in that situation. In the case of discounts, determination of whether or not a discount for prior investments is an arm's-length amount will be unusually difficult.

The committee does not intend to alter in any manner the legal concept of an economic interest which has been developed judicially and administratively over many years. However, the committee believes that taxpayers should be permitted to recover investments made in fields (when they have acquired an economic interest in such fields) before the Tax Reduction Act of 1975 through discounts from the price paid for production from those fields. It is reasonable to expect that investments before that time will be recovered within 10 years.

Explanation of provision

The committee's amendment provides that section 901(f) is not to apply with respect to the purchase and sale of oil or gas from a field if the taxpayer has had an economic interest in that field and if, on March 29, 1975, the taxpayer has made an investment with respect to the field. This will be the case notwithstanding the fact that the taxpayer purchases the oil or gas from that field at less than the fair market value, including a discount which reflects compensation for the prior investment and the price differs from the fair market value for the oil or gas. However, section 901(f) will apply in any case for taxable years beginning after 1985.

It is the intention of the committee that the term "oil or gas field" is not to be narrowly defined. Generally, an oil or gas field is that surface area under which oil or gas has been discovered by the drilling of an oil or gas well indicating the presence of hydrocarbons. The area of an oil or gas field is delineated horizontally as well as vertically. The surface area of an oil or gas field may be delineated by projecting to the surface the outside perimeter of each underlying formation and reservoir in which oil or gas is located and drawing a border around the projections, including all contiguous surface areas. Vertically, an oil or gas field includes the entire area within the border including all underlying formations and reservoirs, at whatever depth, whether or not they were known to exist at the time of the drilling of the initial well.

The committee's amendment does not apply to any field (i.e., section 901(f) will apply for any taxable year to the purchase and sale of production from such field) with respect to which no investment was made on or before March 29, 1975, even if the field is located within the same concession area as another field which is subject to the exception added by the committee's amendment. These investments will be subject to the test of the oil or gas being bought and sold at an arm's length price. No comparable provision is in the House bill.

Effective date

This provision of the committee amendment is to apply to taxable years beginning after December 31, 1974.

Revenue effect

It is estimated that the special rule for cases where there has been an economic interest in a prior year will result in a decrease in budget receipts of $34 million in fiscal year 1977 and of $40 million thereafter.

(*6*) *Production-sharing contracts*

Reasons for change

A problem concerning the allowance of a foreign tax credit for payments to a foreign government in connection with mineral extraction has arisen in the case of production-sharing contracts. These arrangements between the foreign government and oil companies which are becoming increasingly popular involve government ownership of all oil and gas reserves. Under these arrangements, the oil company operates as a contractor furnishing services and know-how. All management and control of production is retained by a government-owned entity which has the exclusive right to explore and develop the government's mineral property. All tangible property is owned by the government-owned entity. Ordinarily, the contractor is compensated for its costs in the form of a share (not to exceed a given percentage each year) of the production from a contract area. The remainder of the production is divided between the contractor according to negotiated percentages. (Any unrecovered costs are recovered in subsequent years.) The law of the foreign country generally provides that the government-owned oil company is to pay to the government each year a portion of its production share. This payment is said to constitute (among other things) the payment of the contractor's tax liability on its behalf so that the contractor does not directly pay any income taxes under the country's general corporation tax.

The Internal Revenue Service recently issued Revenue Ruling 76-215, 1976 I.R.B. No. 23, holding that the contractor under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to the foreign government. The grounds for this holding were, in part, that since the foreign government already owns all of the oil and gas, there is no payment to the government by the contractor. Furthermore, even if a payment by, or on behalf of, the contractor could be identified, the IRS views such a payment as in the nature of a royalty, rather than a tax.

In 1969, the Internal Revenue Service issued Revenue Ruling 69–388, 1969–2 C.B. 154, which held that certain payments made pursuant to a contract to explore for, develop, and produce oil in Indonesia are creditable. The contracts to which that Ruling applied were not production-sharing contracts but the Ruling was apparently relied on by oil companies entering into production-sharing contracts. In view of the fact that the scope of the prior Ruling was not clear, the Internal Revenue Service exercised its discretion to apply Revenue Ruling 76–215 only prospectively to claims for credits for taxes paid in taxable years beginning after June 30, 1976.

While the committee takes no position on the correctness of the IRS ruling, the committee feels that oil companies operating under existing production-sharing contracts should have a reasonable time to renegotiate their contracts with the foreign government. Thus, assuming the ruling is sustained, if challenged, generally the companies should continue to be allowed the foreign tax credit for another five years. In the meantime, however, the oil companies should not be allowed to generate excess foreign tax credits under the contracts that can be used to offset tax on other income.

Explanation of provision

The committee's amendment allows a limited foreign tax credit for a limited period in the case of production-sharing contracts to which Revenue Ruling 76–215 applies. Under this amendment, amounts which are designated by a foreign government under certain production-sharing contracts as income taxes are treated as creditable income, war profits, and excess profits taxes even though the amounts would not otherwise be treated as creditable taxes. Moreover, the amendment only applies to taxes not creditable by reason of that ruling. Thus, to the extent that payments are treated as taxes, this amendment does not apply to those payments.

However, the total amount treated as creditable taxes under this provision is not to exceed the lesser of two amounts. The first amount is the total foreign oil and gas extraction income with respect to production-sharing contracts covered under the rule multiplied by the U.S. corporate tax rate (generally 48 percent) less the otherwise allowable (if any) foreign tax credits attributable to income from those contracts. The second amount is the total foreign oil and gas extraction income multiplied by the U.S. corporate tax rate (generally 48 percent) less the total amount of the otherwise allowable foreign tax credits (if any) attributable to the total foreign oil and gas extraction income.

The production-sharing contracts covered by this provision are those contracts for which the IRS has published a ruling disallowing foreign tax credits for taxes paid in taxable years on or after June 30, 1976, but has not disallowed claims for tax credits for taxable years beginning before that date.

Thus, for example, assume that the taxpayer for 1977 derives a total of $100 of foreign oil and gas extraction income; that $10 of that amount is derived from production-sharing contracts to which this provision applies; that the taxpayer pays a total of $45 in foreign taxes on the foreign extraction income (not including any amounts claimed as taxes under production-sharing contracts to which this provision applies); and that $6 of tax credit was disallowed on the income from the production-sharing contracts. Under these facts, the taxpayer is allowed a foreign tax credit for amounts under the production-sharing contract equal to $3, the lesser of (48 percent of $10) or ((48 percent of $100) minus $45).

This provision will apply only to production-sharing contracts entered into before April 8, 1976, and will apply only with respect to taxes designated as having been paid under such contracts before January 1, 1982.

The committee's special rule applies only with respect to production-sharing contracts for which the Internal Revenue Service will disallow claims for a foreign tax credit for taxes paid in taxable years beginning on or after June 30, 1976, but will not disallow claims for taxes paid for taxable years beginning before June 30, 1976.

Effective date

The special rule for production-sharing contracts is to apply for taxable years beginning on or after June 30, 1976.

Revenue effect

It is estimated that this provision will decrease budget receipts by $23 million in fiscal year 1977 and $27 million in fiscal year 1978.

e. Third-tier foreign tax credit under subpart F

Present law

Under present law, when amounts which are foreign base company income are included in the income of a domestic corporation under subpart F with respect to the undistributed earnings of a controlled foreign corporation, a proportionate part of the foreign taxes paid by the foreign corporation are deemed paid by the domestic corporation, and a foreign tax credit is available to the domestic corporation with respect to those taxes. These rules are substantially parallel to the foreign tax credit rules on actual distributions. However, this deemed-paid credit is available for subpart F income only if the controlled foreign corporation is a first-tier foreign corporation (which must be at least 10-percent owned by a domestic corporation) or a second-tier foreign corporation (which must be at least 50 percent owned by a first-tier foreign corporation).

Reasons for change

These rules are inconsistent with the foreign tax credit rules applicable with respect to dividends actually distributed. Actual dividends carry with them a proportionate part of the foreign taxes paid by third-tier foreign corporations, as well as first- and second-tier foreign corporations. Moreover, in order to qualify as a second-tier corporation with respect to dividends actually distributed, only 10 percent of the stock need be held by a first-tier foreign corporation.

The committee believes that the foreign tax credit rules with respect to amounts included in income under subpart F should be consistent with the rules applicable to dividends actually distributed. Taxpayers tend to structure their business operations in accordance with the rules applicable with respect to actual distributions. The rules of subpart F are now overly harsh when they deny a foreign tax credit to a taxpayer who would have been entitled to a credit had there been an actual distribution.

When subpart F was added in 1962, the rules for computing the deemed-paid foreign tax credit with respect to dividends were applicable only with respect to foreign taxes paid by a first-tier foreign subsidiary (defined as being at least 10 percent owned by a domestic corporation) or a second-tier foreign subsidiary (defined as being at least 50 percent owned by a first-tier foreign corporation). The foreign tax credit rules under subpart F were made applicable under the same circumstances as actual dividends.

In 1971, the deemed-paid foreign tax credit with respect to dividends actually distributed was expanded to apply to foreign taxes paid by a larger class of second-tier corporations and by third-tier foreign corporations. The committee's amendment conforms the subpart F foreign tax credit rules to the 1971 change in the deemed-paid foreign tax credit for actual dividend distributions.

Explanation of provisions

The committee's amendment makes two changes to the present rules for computing a foreign tax credit with respect to amounts included in income under subpart F. First, the amendment provides that the foreign tax credit is applicable with respect to foreign taxes paid by a third-tier foreign corporation whose undistributed income is taxed to the shareholder. Second, the amendment liberalizes the stock ownership test applicable to second-tier foreign corporations.

Under the committee's amendment, a foreign corporation qualifies as a second-tier foreign corporation if at least 10 percent of its voting stock is owned by a first-tier foreign corporation, at least 10 percent of the voting stock of which must be owned by a domestic corporation. A foreign corporation qualifies as a third-tier foreign corporation if at least 10 percent of its voting stock is owned by a second-tier foreign corporation.

However, with respect to a second-tier foreign corporation, the foreign tax credit is not available unless the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation and the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation when multiplied together equal at least 5 percent. With respect to a third-tier foreign corporation, the foreign tax credit is not available unless the percentage of voting stock in the first-tier foreign corporation owned by the domestic corporation and the percentage of voting stock in the second-tier foreign corporation owned by the first-tier foreign corporation and the percentage of voting stock in the third-tier foreign corporation owned by the second-tier foreign corporation when multiplied together equal at least 5 percent.

There is no comparable provision in the House bill.

Effective date

The committee's amendment applies with respect to earnings and profits of a foreign corporation included in gross income after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $4 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981.

f. Source of underwriting income

Present law

Under present law, the source of insurance underwriting income is unclear. Neither the Internal Revenue Code nor the Income Tax Regulations set forth a specific rule for determining the source of insurance underwriting income. It is the position of the Internal Revenue Service, however, that the source of such income is to be determined on the basis of where the incidents of the transaction which produce the income occur. Under this rule, income produced from insurance underwriting contracts negotiated and executed in the United States, regardless of the location of the insured risks, is generally deemed to be from sources within the United States. This rule apparently applies even though the insurance contract is actually written by a foreign company.

Reasons for change

The present source rule applicable to insurance underwriting income is vulnerable to artificial manipulation by taxpayers. By simply changing the place where a contract is negotiated and executed, a taxpayer can change the source of the underwriting income produced by the contract. The current source rule in some situations also can result in double taxation. It is not uncommon for United States corporations doing business abroad through foreign subsidiaries to negotiate and execute insurance contracts in the United States which cover its overseas operations. The insurance policies, however, frequently must be issued in the foreign jurisdiction in which the insured's risk is located in order to comply with local insurance laws or for other business reasons. Although the underwriting income in these circumstances generally would be subject to foreign taxation, the income would be deemed United States source income, which in turn would reduce the amount of the foreign tax credit available to the taxpayer.

Explanation of provision

The committee's amendment would establish a new source rule applicable to insurance underwriting income. Under the new rule, underwriting income derived from the insurance of U.S. risks would be income from sources within the United States. All other underwriting income would be considered income from sources without the United States. The new source rule is not intended to change existing law with respect to the determination of whether foreign source income is effectively connected with the conduct of a trade or business within the United States.

Effective date

The committee's amendment applies to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will decrease receipts by less than $5 million annually.

6. Exclusion From Gross Income and From Gross Estate of Portfolio Investments in the United States of Nonresident Aliens and Foreign Corporations (sec. 1041 of the bill, and secs. 861, 872, 883, 897, and 2105 of the Code)

Present law

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 [28] if such income or gain is not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881).[29] However, a number of exemptions have been provided from this 30-percent tax on gross income. Interest from deposits with persons carrying on the banking business are exempt (secs. 861(a)(1)(A) and 861(c)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States is also not subject to the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Under the expired interest equalization tax, interest on certain debt obligations which were part of an issue with respect to which an election had been made for IET purposes are exempt (secs. 861(a)(1)(G) and 4912(c) of the code). Moreover, there is no estate tax liability with respect to a debt obligation or a bank deposit if the interest on such obligation or deposit would not be subject to the 30-percent withholding tax if it were received by the decedent at the time of his death (secs. 2104 and 2105).

In addition to the above exemptions provided in the Internal Revenue Code, various income tax treaties of the United States provide for either an exemption or a reduced rate of tax for interest and dividends paid to foreign persons if the income is not effectively connected with the conduct of a trade or business within the United States.

Reasons for change

The committee believes that the imposition of a withholding tax on obligations issued by U.S. persons can impair the ability of U.S. corporations to raise capital in foreign markets. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments.[30] In contrast, the United States' withholding tax is generally imposed, although as indicated above there are numerous exceptions to the general rule depending upon the nature of the issuer or the residence of the recipient of the interest income. The lack of a broad exemption under present law has in some cases made it difficult to trade U.S. obligations in international bond markets, since holders of international obligations wish to be assured that there will be no withholding tax imposed on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. borrowers often have to agree to reimburse holders of its debt instruments for any U.S. withholding tax which may be due. This raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

[28] 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).

[29] 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.

[30] Austria, Denmark, France, Finland, Japan, Netherlands, Norway, and Sweden provide an exemption from withholding taxes on interest paid to foreign lenders.

. Prior to the termination of the IET, U.S. borrowers were able to secure an exemption for foreign lenders by electing to have the U.S. obligations subject to the IET. In this way interest paid with respect to such obligations was exempt from the 30-percent withholding tax. However, the termination of the IET on June 30, 1974, has again made it more difficult for U.S. borrowers to obtain funds from foreign markets. In order to enable U.S. borrowers to obtain funds for their domestic as well as foreign capital needs your committee believes that an exemption should be provided for interest paid to foreign lenders (other than direct investors) except where the income is effectively connected with the conduct of a trade or business in the United States by the foreign lender.

Explanation of provision

Withholding tax.—For the reasons indicated above, under the committee amendment, interest paid by a U.S. person is generally to be exempt from U.S. tax (under secs. 871(a) and 881) if received by a nonresident alien individual or a foreign corporation. The term "United States person" has the meaning assigned to it in section 7701 (a) (30) and means a citizen or a resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust (other than a foreign estate or trust). In addition, the exemption applies to interest paid by the United States Government or any agency or instrumentality thereof, or by any State or political subdivision thereof. For purposes of this provision the term "interest" includes original issue discount. The House bill did not contain a comparable provision.

Interest is subject to tax and is not entitled to the exemption if it is effectively connected with the conduct of a trade or business within the United States. Also, interest is not exempt if the payor U.S. corporation or a U.S. person is owned directly by foreign persons. In the case of payments from domestic corporations, direct ownership exists if foreign persons own or are considered as owning more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the corporation paying the interest and if the recipient of the interest owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership by foreign persons exists if such persons own or are considered as owning more than 50 percent of the capital or profits interest of the partnership and the recipient of the interest owns or is considered as owning 10 percent or more of the capital or profits interest of the partnership.

In applying the 10- and 50-percent ownership tests, the committee's amendment provides specific attribution rules for determining what constitutes direct and indirect ownership. Stock owned directly or indirectly by or for a corporation, partnership, trust or estate is considered as being owned directly by the shareholders, partners or beneficiaries. If 50 percent or more in value of the stock in a corporation is owned directly or indirectly by or for any person the corporation is considered as owning the stock owned directly or indirectly by or for that person. However, stock considered under these rules as being owned by a partnership, estate, trust or corporation is not considered as being actually owned by a partner, beneficiary or shareholder of such entity. Stock owned directly or indirectly by or for a partner or a beneficiary of an estate or a trust is considered as being owned by the partnership, estate or trust. Stock owned directly or indirectly, by or for a person who is considered the owner of any portion of a trust (under subpart E of part 1 of subchapter J (relating to grantor trusts)) is considered as being owned by the trust.

Although the committee's amendment provides an exemption for payments of interest to foreign persons, the committee does not intend to waive the information reporting provisions on these exempt amounts. Accordingly, the committee's amendment authorizes the Secretary of the Treasury to prescribe regulations for the reporting of interest which is made exempt from tax by the bill. Your committee expects that regulations will be prescribed under these provisions so that the Secretary can report back to the committee the foreign persons (and their country of residence) who are receiving the benefits of this exemption.

To prevent U.S. persons from indirectly taking advantage of this exemption, the bill provides that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the exemption from gross income for interest.

Estate tax.—In the case of nonresident alien individuals, the amendment also deals with the estate tax problem, formerly dealt with by the IET. That tax, before repeal, eliminated any potential U.S. estate tax liability in the case of obligations the income from which, if received by the decedent at the time of his death, would be exempt from tax.

As a result, the bill provides an exclusion from the estate tax for debt obligations if any interest received by a decedent at the time of his death would be eligible for the exclusion provided for by your committee.

Exemption made inapplicable.—The bill provides that if the Secretary of the Treasury determines that the United States is not receiving sufficient information from a foreign country to identify the true beneficial recipients of the interest payments and if the Secretary believes such information is necessary in order to insure that the benefits of this provision are only obtained by foreign persons who are entitled to the exemption, the exemption will no longer apply to payments addressed to or for the account of persons within that country for future issuances of debt obligations. The termination is to continue until the Secretary determines that the exchange of information between the United States and that country is sufficient to identify the beneficial recipients of the interest. Any termination of the exemption for interest will also automatically terminate the exemption from the estate tax on the debt obligations.

Bank interest.—The committee's amendment also continues the exemption in present law for interest on deposits with persons carrying on the banking business without any termination date. The present exemption for interest on deposits expires for interest paid after December 31, 1976. The bill makes the exemption for interest on deposits permanent by eliminating the language of present law which would terminate the provision for interest paid after December 31, 1976. The House bill also made permanent the provision with respect to bank interest.

Effective dates

The amendments providing for the income tax exemption apply to interest paid after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations apply to estates of decedents dying after the date of enactment.

Revenue effect

It is estimated that these provisions will result in a decrease in tax liability of $8 million for calendar year 1976, and $130 million for calendar year 1977. In 1977, $20 million is attributable to the exemption for nonbank account interest, and $110 million is attributable to the exemption for bank account interest.

This provision will reduce budget receipts by $73 million in fiscal year 1977, $137 million in fiscal year 1978, and $183 million in fiscal year 1981.

7. Changes in Ruling Requirements Under Section 367 and Changes in Amounts Treated as Dividends (sec. 1042 of the bill and secs. 367, 1248, and 7477 of the Code)

Present law

Present law provides that certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to its shareholders. However, when a foreign corporation is involved in certain of these types of exchanges, tax-free treatment is not available unless prior to the transaction the Internal Revenue Service has made a determination that the exchange does not have as one of its principal purposes the avoidance of federal income taxes. Under present practice this determination is made by issuing a separate ruling for each transaction. The required determination must be obtained before the transaction in all cases unless the transaction involves only a change in the form of organization of a second (or lower) tier foreign subsidiary with no change in ownership.

The advance ruling requirement of section 367 applies to exchanges involving contributions of property to controlled corporations (sec. 351), all tax-free corporate reorganizations (secs. 354, 355, 356 and 361), and liquidation of subsidiary corporations (sec. 332). In determining the extent to which gain (but not loss) is recognized in these exchanges, a foreign corporation is not considered a corporation unless it is established to the satisfaction of the Internal Revenue Service that the exchange "is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes". Since corporate status is essential to qualify for the tax-free organization, reorganization and liquidation provisions, failure to satisfy the Commissioner under section 367 can result in the recognition of gain to the participant corporations and shareholders. Furthermore, there is no effective way a taxpayer can appeal an adverse decision by the Commissioner to the courts because the statute requires the Commissioner's, not the court's, satisfaction.

In 1968, the Internal Revenue Service issued guidelines[31] as to when favorable rulings "ordinarily" would be issued. As a condition

[31] Rev. Proc. 68-23, 1968—1 Cum. Bull. 821.

to obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines require the taxpayer to agree to include certain items in income (the amount to be included is called the section 367 toll charge). For example, if a domestic corporation transfers property to a foreign subsidiary (a transaction otherwise accorded tax-free treatment under section 351), the transaction will be given a favorable ruling only if the domestic corporation agrees to include in its gross income for its taxable year in which the transfer occurs an appropriate amount to reflect realization of income or gain with respect to certain types of assets (*e.g.*, inventory, accounts receivable, and certain stock or securities) transferred to the foreign corporation as part of the transfer. If the transaction involves the liquidation of a foreign corporation into a domestic parent, a favorable ruling will be issued if the domestic parent agrees to include in its income as a dividend for the taxable year in which the liquidation occurs the portion of the accumulated earnings and profits of the foreign corporation which are properly attributable to the domestic corporation's stock interest in the foreign corporation. These two cases illustrate that the statutory standard for determining that a transaction does not have as one of its principal purposes tax avoidance has evolved through administrative interpretation into a requirement generally that tax-free treatment be permitted only if the U.S. tax on accumulated earnings and profits (in the case of transfers into the United States by a foreign corporation) or if the U.S. tax on the potential earnings from liquid or passive investment assets (in the case of transfers of property outside the United States) is paid or is preserved for future payment.

In addition to section 367, section 1248 provides for the imposition of a full U.S. tax on accumulated profits earned abroad when they are repatriated to the United States in cases where gain is recognized on the sale or exchange (or liquidation) of stock of a controlled foreign corporation held by a U.S. person owning 10 percent or more of the voting stock. In these cases, the gain is included in the gross income of the U.S. person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock was held by the U.S. person while the foreign corporation was a controlled foreign corporation. This provision applies to post-1962 accumulated earnings.

Reasons for change

Several problems have developed insofar as section 367 and the related provisions of section 1248 are concerned. First, the advance ruling requirement often results in an undue delay for taxpayers attempting to consummate perfectly proper business transactions. Second, a number of cases have arisen where a foreign corporation was involved in an exchange within the scope of the section 367 guidelines without the knowledge of its U.S. shareholders, and thus no request for prior approval was made. In a case of this type, an otherwise tax-free transaction becomes a taxable transaction, and if a second or lower tier foreign subsidiary is involved the U.S. shareholders of the controlled foreign corporation may be taxed under the subpart F rules. This can occur under the Service's section 367 guidelines despite the fact that a favorable ruling would clearly have been issued by the Internal Revenue Service had it been requested prior to the transaction.

The third area of difficulty in the present administration of section 367 concerns situations where the IRS requires a U.S. shareholder to include certain amounts in income as a toll charge even though there is no present tax avoidance purpose but, rather, only the existence of a potential for future tax avoidance. This occurs under the section 367 guidelines because of limitations in the carryover of attribution rules (sec. 381). The Internal Revenue Service in some cases only has the option either of collecting an immediate tax or of collecting no tax at all since the IRS has in those cases no authority to defer payment of the tax until the time that the avoidance actually arises, except by entering into closing agreement with the taxpayer.

The fourth problem concerns the fact that since the law requires the satisfaction of the Commissioner, a taxpayer is unable to go through with a transaction and litigate in the courts the question of whether tax avoidance is one of the purposes of the transactions. While your committee generally approves the standard applied by the IRS there may be cases where these standards are inappropriate or are not being correctly applied. Your committee believes it is fair to permit taxpayers to litigate these questions in the courts.

The committee further believes that the interpretation of the rules governing exchanges described in section 367 should not be done in individual rulings but should be provided by clear and certain regulations. While it is recognized that the present rules are necessarily highly technical and largely procedural and while it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings, unnecessary barriers to justifiable and legitimate business transactions should be avoided. Your committee believes that U.S. taxpayers participating in certain types of transactions involving foreign corporations should be able to determine the tax effects of the transaction from the statute and accompanying regulations rather than being required to apply to the Internal Revenue Service for a determination in advance of the transaction. Only in those types of transactions where the amount of tax, if any, which must be paid to protect against tax avoidance can only be determined by judging the specific facts of the case should the taxpayer be required to obtain a determination from the Internal Revenue Service. Moreover, in cases where such a ruling is to be required, taxpayers should be permitted to obtain the ruling within some limited time after the transaction has been begun.

A problem also exists with the provision which seeks to impose a tax at ordinary income rates to the extent of post-1962 accumulated earnings and profits upon certain otherwise taxable sales or exchanges of stock in a controlled foreign corporation (sec. 1248). In some situations other than those covered by section 367, a domestic corporation is entitled to nonrecognition of any gain if it sells, exchanges, or distributes its property. When transactions coming within the scope of these nonrecognition provisions involve the sale or distribution of stock in a controlled foreign corporation, section 1248 does not apply since that provision applies only when gain is recognized. Thus, any ordinary income tax on the repatriation of accumulated earnings and profits of the controlled foreign corporation is lost. For example, a

U.S. parent corporation is able to avoid ordinary income tax on foreign earnings if it sells the stock in a controlled foreign subsidiary as part of a plan of complete liquidation (pursuant to sec. 337). The U.S. corporation is entitled to nonrecognition of gain (or loss) on the sale or exchange of the stock and is not required to recognize any gain when it distributes its property (including the sales proceeds) to its shareholders in complete liquidation. The shareholders pay a capital gains tax on the difference between the value of the property received in liquidation and their basis in the stock of the liquidating corporation. But no ordinary income tax is paid on the foreign earnings.

A similar problem is involved, for example, if a U.S corporation distributes stock in a controlled foreign corporation as a dividend. The distributing corporation may not recognize gain on the distribution and the distributee shareholders (if they are individuals) acquire a fair market value basis in the distributed stock and are not treated as holding the stock for the period it was held by the corporation (sec. 1223). Thus, although the shareholders are taxed on the dividend out of the domestic corporation's earnings, there is no corporate tax on the earnings of the foreign corporation.

The committee believes that the availability of non-recognition treatment for distributions or exchanges of stock of controlled foreign corporations in situations not presently covered under section 367 or 1248 detracts substantially from the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. In your committee's view, nonrecognition should not be available to the selling or distributing corporation but, rather, such corporation should be required to include in income, as a dividend, its share of post-1962 foreign earnings and profits.

Explanation of provisions

The committee's amendment approaches the problems outlined above first by amending section 367 to establish separate rules for two different groups of transactions: (i) transfers of property from the United States, and (ii) other transfers (this latter group including transfers into the United States and those which are exclusively foreign). Transactions in the first group generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transfers in the second group primarily include those where the statutory purpose in most cases is to preserve the taxation of accumulated profits of controlled foreign corporations. The committee amendment is substantially similar to the House bill.

Transfers from the United States.—With respect to the first group (sec. 367(a)), it is provided that if in connection with an exchange described in sections 332, 351, 354, 355, 356, or 361, there is a transfer of property (other than stock or securities of a foreign corporation which is a party to the exchange) by a U.S. person to a foreign corporation, the foreign corporation will not be considered a corporation (for purposes of determining gain) unless, pursuant to a request filed not later than the close of the 183rd day after the beginning of the exchange, the taxpayer establishes to the satisfaction of the Internal Revenue Service that the exchange did not have as one of its principal purposes the avoidance of Federal income taxes. An exchange will not be considered to begin with a board of directors or similar decision, but with the transfer of assets. The term "party to the exchange" as used in this provision includes a party to the reorganization (as defined in sec. 368(b)) and the transferor and transferee in an exchange other than a reorganization. Types of "outbound" transfers falling within this category include exchanges involving transfers of property to a foreign corporation, the liquidation of a U.S. subsidiary into a foreign parent, the acquisition of a U.S. corporation's assets by a foreign corporation in a qualified reorganization and the acquisition of stock in a U.S. corporation by a foreign corporation in a type "B" reorgnization.[32] Exchanges where the only transfer of property out of the United States is stock of a foreign corporation which is a party to the exchange are treated as transfers into the United States, since the principal concern in that case is the avoidance of taxation on the accumulated earnings of the foreign corporation. The rules for outbound transactions apply only to transfers of property by U.S. persons; they do not apply to transfers which are between two foreign corporations or between a foreign corporation and a foreign individual.

The amendment thus provides that for transfers of property out of the United States the requirement of an advance ruling is replaced by a requirement that the taxpayer file a request for clearance with the Internal Revenue Service within 183 days after the beginning of the exchange. Even this post-transaction clearance from the Internal Revenue Service may not be required in certain clearcut situations involving outbound transfers where significant tax avoidance possibilities do not exist or where the amount of any section 367 toll charge can be ascertained without a ruling request. The bill provides that the Secretary is to designate by regulations those transactions which for these reasons do not require the filing of a ruling request. For transactions designated by the regulations, taxpayers may go ahead with the transaction without a ruling but are subject to any section 367 toll charge prescribed by the regulations. For example, if a section 351 transfer to a foreign corporation involves only the transfer of cash and inventory property, the Secretary may by regulations designate the transaction as one which does not require the filing of a request, although the regulations would require the inventory to be taken into income.

The committee amendment contains a provision not found in the House bill which deals with the case where a taxpayer obtains a favorable ruling that there is no tax avoidance in an exchange. If, after the beginning of the exchange, there are transfers or exchanges which are treated by the Secretary as part of the exchange with respect to which the ruling was obtained although not described in the ruling, the taxpayer may file a new request for a ruling not later than the 183rd day after the beginning of the subsequent transfer or exchange. This ruling request may cover the question as to whether the entire exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. This amendment allows a taxpayer a new 183-day period in which to file a ruling request with respect to a transfer which the Internal Revenue Service sees as a step in, or

[32] Also included as "outbound" transfers are transfers of assets from one domestic corporation to another in a "C" reorganization where the acquiring corporation is controlled by foreigners who were not in control of the acquired corporation before the reorganization.

part of, an earlier transfer for which a ruling has been obtained but which does not cover the latter transfer.

Tax Court review.—In the case of an actual controversy involving a determination or a failure to make a determination by the Secretary as to whether a plan has as one of its principal purposes the avoidance of Federal income taxes, the committee's amendment provides that a taxpayer may litigate the determination in the Tax Court. The commitee's amendment follows the declaratory judgment procedures which were added to the tax law in the recently enacted pension reform act. In addition, the Tax Court is to review any terms and conditions which the Secretary seeks to impose upon a taxpayer in making the determination that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of income taxes.

The Tax Court is to review whether the Secretary's determination as to tax avoidance is reasonable and whether the conditions imposed in making the determinations are reasonable conditions in order to prevent the avoidance of income tax. If the Tax Court finds that the Secretary's terms and conditions are not reasonable, then the Tax Court is to make a declaration as to the terms and conditions which it finds to be reasonable in order to prevent the avoidance of income taxes.

A request for a declaratory judgment under these proceedings can only be filed by a petitioner who is a transferor or transferee of stock, securities or property in an exchange where money or other property is being transferred from the United States (sec. 367(a)(1)). In addition, no proceeding may be begun unless the exchange with respect to which the declaration is being sought has begun. It is not necessary for this purpose that the full exchange has been completed. In addition, this requirement will be satisfied although the taxpayer has transferred assets conditioned upon a stipulation that, if there is a failure to obtain from the Internal Revenue Service a determination that the transaction does not have as one of its principal purposes the avoidance of Federal income taxes, the transaction will not be completely consummated and, to the extent possible, the assets transferred are to be returned.

Any such declaration is to have the force and effect of a final judgment or decree and is to be reviewable as such. The court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or upon any new matter which the Service may wish to introduce at the time of the trial. The Tax Court judgment, however, is to be based upon a redetermination of the Internal Revenue Service's determination. The burden of proof rules are to be developed by the Tax Court under its rule-making powers. Under the existing Tax Court rules the taxpaver has the burden of proof as to matters in the notice of deficiencv. As to matters raised by the Service at the time of the Tax Court hearing, the Service has the burden. It is expected that rules similar to these will be adopted by the Tax Court.

The judgment of the Tax Court in a declaratory judgment proceeding is to be binding upon the parties to the case based upon the facts as presented to the court in the case for the year or years involved. This, of course, does not foreclose action (within the limits of the legal doctrines of estoppel and stare decisis) if an examination of the facts of the exchange indicates that they differ from those stated in the ruling. It is anticipated that the normal rules of the Federal courts as they relate to declaratory judgment procedure will apply.

For a petitioner to receive a declaratory judgment from the Tax Court under this provision, he must demonstrate to the court that he has exhausted all administrative remedies which are available to him within the Internal Revenue Service. Thus, he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination. To exhaust his administrative remedies a party must satisfy all procedural requirements of the Service. For example, the Service may decline to make a determination if a petitioner fails to supply the Service with the necessary information on which to make a determination.

A petitioner is not to be deemed to have exhausted his administrative remedies in cases where there is a failure by the Internal Revenue Service to make a determination before the expiration of 270 days after the request for such a determination is made. Once this 270-day period has elapsed, a petitioner who has exhausted his remedies may bring an action (within 91 days) even though there has been no notice of determination from the Internal Revenue Service.

No petition to the Tax Court may be filed after 90 days from the date on which the Internal Revenue Service sends by certified or registered notice to a person of his determination (including refusals to make determinations) as to whether there is a tax avoidance purpose in an exchange. Such notice is to be treated by the taxpayer as exhaustion of administrative remedies. This 90-day period does not begin to run until the Secretary sends the taxpayer the required notice.

Tax Court Commissioners.—In order to provide the court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the Commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide. The committee wishes to make clear that it is not intended that this be construed as indicating that all of these proceedings should be heard by commissioners and decisions entered by them rather than by the judges of the court. Instead, it is intended to provide more flexibility to the Tax Court in the use of commissioners in these types of cases. It is anticipated, for example, that if the volume of these cases should be large, the Tax Court will expedite the resolution of these cases by authorizing commissioners to hear and enter decisions in cases where similar issues have already been heard and decided by the judges of the court or in other cases where, in the discretion of the court, it is appropriate for the commissioners to hear and decide cases.

These procedures apply with respect to proceedings filed with the Tax Court after the date of the enactment of this bill only with respect to exchanges beginning after October 9, 1975.

Other transfers.—The Committee's amendment establishes separate treatment under section 367(b) for a second group of transfers which consists of exchanges described in sections 332, 351, 354, 355, 356, and 361, that are not treated as transfers out of the United States (under section 367(a)) under the rules described above. With respect to these other transactions, a ruling is not required. Instead, a foreign corporation will not be treated as a corporation to the extent that the Secretary of the Treasury provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes. These regulations are to be subject to normal court review as to whether the regulations are necessary or appropriate for the prevention of avoidance of Federal income taxes. Thus, a taxpayer may challenge a proposed deficiency with respect to an exchange dealt with in the regulations by arguing in the courts that the regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of Federal incomes taxes. If the court should agree with the taxpayer, it is to apply the balance of the regulations to the extent appropriate.

Transfers covered in these regulations are to include transfers constituting a repatriation of foreign earnings. Also included are transfers that involve solely foreign corporations and shareholders (and involve a U.S. tax liability of U.S. shareholders only to the extent of determining the amount of any deemed distribution under the subpart F rules). It is anticipated that in this latter group of exchanges, the regulations will not provide for any immediate U.S. tax liability due but will maintain the potential tax liability of the U.S. shareholder.

It is the committee's intention that the regulations promulgated with respect to this group of transactions will enable taxpayers to determine the extent (if any) to which there will be any immediate U.S. tax liability resulting from any transaction. The bill provides (sec. 367(b)(2)) that the regulations promulgated with respect to this group will include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person, including regulations providing the circumstances under which (i) gain is recognized currently and included in income, as a dividend, or both, or (ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date. The regulations may also provide the extent to which adjustments are to be made to the earnings and profits of any corporation, the basis of any stock or securities, and the basis of any assets.

Examples of transfers into the United States which are to be treated within this group (sec. 367(b)(1)) include: (i) the liquidation of a foreign corporation into a domestic parent; (ii) the acquisition of assets of a foreign corporation by a domestic corporation in a type "C" or "D" reorganization; and (iii) the acquisition of stock in a foreign corporation by a domestic corporation in a type "B" reorganization. With respect to transfers which exclusively involve foreign parties (i.e., where no U.S. persons are parties to the exchange), examples of situations coming within section 367(b)(1) include: (i) the acquisition of stock of a controlled foreign corporation by another foreign corporation; (ii) the acquisition of stock of a controlled foreign corporation by another foreign corporation which is controlled by the same

U.S. shareholders as the acquired corporation; (iii) the acquisition of the assets of a controlled foreign corporation by another foreign corporation; (iv) the mere recapitalization of a foreign corporation (type "E" reorganization); and (v) a transfer of property by one controlled foreign corporation to its foreign subsidiary. For these exclusively foreign transactions, it is anticipated that regulations will provide for no immediate U.S. tax liability.

The Secretary's authority to prescribe regulations relating to the sale or exchange of stock in a foreign corporation includes authority to establish rules pursuant to which an exchange of stock in a second tier foreign corporation for other stock in a similar foreign corporation will result in a deferral of the toll charge which otherwise would be imposed based on accumulated earnings and profits. This deferral could be accomplished by designating the stock received as stock with a deferred tax potential in a manner similar to section 1248 without reference to the December 31, 1962, date; the amount includable as foreign source dividend income upon the subsequent disposition of the stock in question results in dividend income only to the extent of the gain realized on the subsequent sale or exchange. In addition, if a second tier foreign subsidary is liquidated into a first tier foreign subsidiary, the regulations may provide that the tax which would otherwise be due in the absence of a ruling[33] is deferred until the disposition of the stock in the first tier foreign subsidiary.

Transfers treated as exchanges.—As under present law a distribution of stock or securities (under section 355) is treated as an exchange whether or not it is an exchange. Also, a transfer of property to a foreign corporation in the form of a contribution of capital by one or more persons having (after application of the ownership attribution rules of section 318) at least 80 percent of the total combined voting power of all classes of stock entitled to vote is treated as an exchange of the property contributed to the corporation in return for the equivalent value of stock of the corporation.

Transitional rules.—The amendments made to section 367 generally apply to exchanges, within the meaning of section 367, beginning after October 9, 1975. However, in order to permit the Internal Revenue Service sufficient time to develop the regulations required for transfers into the United States and between foreign corporations, the bill establishes a transition rule requiring that these regulations need not be effective until January 1, 1978. In the intervening period transactions which would otherwise be covered by those regulations are covered by the rules applicable generally to transfers out of the United States, namely a ruling is required. Moreover, in the case of any exchange (as described in section 367 as in effect on December 31, 1974), in any taxable year beginning after 1962 and before 1976, which does not involve the transfer of property to or from a U.S. person, a taxpayer has for purposes of section 367 until 183 days after the date of the enactment of this Act to make a request to the Secretary for a finding that such exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes so that for purposes of that section a foreign corporation is to be treated as a foreign corporation.

[33] See Rev. Rul. 64–157, 1964—1 (Part 1) Cum. Bull. 139.

The committee amendment adds a special rule (not included in the House bill) in the case of certain past liquidations of a foreign subsidiary which entitle the taxpayer to apply the new provisions of the law and obtain a refund or a credit of any overpayment by reason of the application of the new provisions notwithstanding the fact that the refund or overpayment would otherwise be prevented by a court case or the statute of limitations. If a refund or a credit is allowed, however, no interest is to be paid on the refund or credit for any period prior to the date of enactment.

The situation provided for in the amendment covers the case where a foreign subsidiary is liquidated by its U.S. parent and in an earlier year stock of a lower-tier foreign subsidiary was distributed to the parent as a dividend. Since the stock of the lower-tier subsidiary is stock described in section 1248, the accumulated earnings with respect to that stock are still subject to dividend treatment upon the sale or exchange of the stock at a gain. This, in effect, could result in double taxation of those earnings. Thus, the committee's amendment requires that the Secretary of the Treasury in promulgating his regulations under section 367(b) write the rules dealing with the computation of earnings and profits and basis of stock in such a manner so that double taxation is avoided.

Sales or exchanges giving rise to dividends.—In addition to the above changes in section 367, your committee's amendment amends the provision which requires that recognized gain on the sale or exchange of stock in a foreign corporation be taxed as a dividend to the extent of earnings and profits of the foreign corporation. The bill applies this provision to situations where gain is not recognized under the provsions of sections 311, 336, and 337. The bill provides (in a new sec. 1248(f)) that if a domestic corporation which meets the stock ownership requirements (of sec. 1248(a)(2)) with respect to a foreign corporation distributes, sells, or exchanges the stock of the foreign corporation in a transaction to which section 311, 336, or 337 applies, then, notwithstanding any other provision, the domestic corporation is to include in gross income as a dividend an amount equal to the excess of the fair market value of the stock of the foreign corporation over its basis to the extent of the earnings and profits of the foreign corporation which were accumulated after 1962 and during the period the stock was held by the domestic corporation while the foreign corporation was a controlled foreign corporation. For this purpose earnings and profits excluded from the dividend treatment (of sec. 1248(a)) are taken into account. Thus, earnings and profits of a less developed country corporation (to the extent provided in sec. 1248(d)(3)) are not taken into account.

If, however, the domestic corporation distributes the stock of a foreign corporation to a shareholder which is a domestic corporation the rule stated above does generally not apply since the basis of the property received is the lesser of fair market value or adjusted basis to the distributing corporation. In this type of situation, the corporate distribute does not receive a stepped up basis as a result of the distribution and, since the potential for the future application of section 1248 still exists, it is not necessary to override the nonrecognition provisions which otherwise apply to a corporate distribution. Consequently, the amendment provides that the distributing corporation need not include any amounts in income if the distribution is to a domestic corporation (i) which is treated as holding the stock for the period the stock was held by the distributing corporation (sec. 1223); and (ii) which, immediately after the distribution, satisfies the stock ownership requirements of section 1248(a)(2) with respect to the foreign corporation.

Finally the rules for taxing the sale of a partnership interest (under sec. 751) are modified so that to the extent any gain from the sale is attributable to stock in a controlled foreign corporation, that gain is to be treated as ordinary income (in the same manner as gain attributable to section 1245 property and section 1250 property is taxed as ordinary income).

These provisions are substantially similar to those in the House bill.

Effective date

The amendments to section 367 and to section 1248 and related provisions apply to sales, exchanges, and distributions taking place after October 9, 1975.

Revenue effect.

It is not expected that these provisions will have any significant impact on the revenues.

8. Contiguous Country Branches of Domestic Insurance Companies (sec. 1043 of the bill and sec. 819A of the Code)

Present law

Under present law, a domestic mutual life insurance company is subject to tax on its worldwide taxable income. If the company pays foreign income taxes on its income from foreign sources it is allowed a foreign tax credit against its otherwise payable U.S. tax on foreign source income.

Reasons for change

Since the beginning of this century, U.S. mutual life insurance companies have been engaged in the life insurance business in Canada. At the present time, the tax imposed by the United States on the operations of Canadian branches of U.S. mutual life insurance companies generally exceeds the tax imposed by the Dominion of Canada and its provinces.

The income of the companies from their Canadian operations is derived generally by the issuance of policies insuring Canadian risks and the investment income from the policyholder reserves on the Canadian risks and any surplus. Quite often the investments of the Canadian branch is in Canadian securities. A separate branch account is maintained by the life insurance companies under which the various income, expense, asset, reserve and other items that relate to Canadian policyholders are segregated on the books of the company. The separate branch accounting system is used for purposes of establishing premiums and policyholder dividend rates based upon the separate mortality and earnings experience of the Canadian branch.

The income earned by the Canadian branch inures solely to the benefit of these Canadian policyholders and is reflected either by dividends paid to them or increases in the size of the reserves and surplus with respect to Canadian policyholders. Thus, the additional cost to the company resulting because U.S. tax liability exceeds Canadian income tax liability on the Canadian branch profits falls primarily upon the Canadian policyholders, since it reduces the reserves and surplus available to the Canadian policyholders. This additional cost makes it more difficult to issue mutual life insurance policies in Canada.

Further, the sale of pension contracts in Canada has been almost precluded by uncertainty as to whether reserves for Canadian pension contracts qualify for the exclusion from gross income which reserves for qualified plans in the United States may obtain.

In contrast, Canada, which generally also taxes Canadian companies on their worldwide taxable income, does not tax Canadian life insurance companies on their foreign source income except when the profits are repatriated.

As a general rule, profits of a U.S. company although earned from sources outside the United States should be subject to U.S. tax when earned since those profits are available for distribution to the shareholders of the company or are available to the company to be used within or without the United States for new investments. However, the profits derived by a Canadian branch of a U.S. mutual life insurance company are not generally available for use other than as reserves and surplus for the Canadian policyholders and may not be used to provide insurance for the U.S. policyholders. This unique feature of mutuality, in which the earnings are restricted to benefit the Canadian policyholders, distinguish the branch operations of a mutual life insurance company from the branch operations of other businesses. For this reason the committee believes it is appropriate to view the Canadian operation as a separate entity in effect owned by the Canadian policyholders. Accordingly, the committee concluded that it was desirable to provide that the profits of the Canadian branch of a U.S. mutual life insurance company are not to be subject to U.S. taxation except in the rare situation where profits are somehow repatriated to the United States for the benefit of the non-Canadian operations or are derived from sources within the United States.

Explanation of provision

Mutual companies.—As a result, the committee's amendment establishes a special system for branches of U.S. mutual life insurance companies which are operated in a contiguous country (i.e., Canada or Mexico). To be eligible for this special treatment a mutual life insurance company must make an election with respect to a contiguous country life insurance branch.

If a proper election is made there is excluded from each item involved in the determination of life insurance company taxable income the items separately accounted for in a separate contiguous country branch account which the mutual life insurance company is required to establish and maintain under the bill. The branch account must include the various items of income, exclusion, deduction, asset reserve, liability, and surplus properly attributable to life insurance contracts issued by the contiguous country branch. The separate accounting is to be made in accordance with the method regularly employed by the company, if the method clearly reflects income derived from, and other items attributable to, the life insurance contracts issued by the contiguous country branch, and in all other cases in accordance with regulations issued by the Secretary. It is expected that the regulations will provide that a system properly reflects income if it provides for an allocation or designation of assets to the contiguous country branch at the time that they are acquired. This requirement is satisfied if the allocation or designation is made on a periodic basis (either monthly or weekly). Once an asset is designated or allocated as a branch asset it must retain that character so long as it is held. All income, expense, gain or loss connected with a branch asset must be accounted for in the branch account. Also, new assets acquired by the company must be credited to the branch account to the extent attributable to reserves and surplus in the branch account.

For purposes of this provision, a branch is a contiguous country life insurance branch if it satisfies three conditions. First, it must issue insurance contracts insuring risks in connection with the lives or health of residents of a country which is contiguous to the United States (i.e., Canada or Mexico). For this purpose an insurance contract means any life, health, accident, or annuity contract or reinsurance contract with respect to these contracts or any other type of contract relating to these contracts. Second, the branch must have its principal place of business in the contiguous country for which it insures risks. Third, the branch, if it were a separate domestic corporation, must be able to qualify as a separate mutual life insurance company.

The committee's amendment provides that an election to establish a separate contiguous country branch is to be treated as a taxable disposition for purposes of recognizing any gain by the domestic company. If the aggregate fair market value of all the invested assets and tangible property which is separately accounted for by the company in the branch account exceeds the aggregate adjusted basis of those assets (for purposes of determining gain) then the company is to be treated as having sold those assets on the first day of the first taxable year for which the election is in effect at the fair market value on that day. The net gain on the deemed sale of these assets is to be recognized notwithstanding any other provision of the Code. The assets taken into account for this determination include all of the invested assets (such as stock and securities) and all tangible property (such as, land, buildings, and equipment) which are separately accounted for in the branch account. However, goodwill, since it is an intangible asset, is not taken into account.

While the committee does not believe that any of the profits of the contiguous country branch can be accumulated for the benefit of the U.S. policyholders (since the branch is treated as operating as a mutual life insurance company and insures risk for policyholders only in a contiguous country and thus any profits would be accumulated for the benefit of the contiguous country policyholders), the committee's amendment nevertheless, in order to provide assurance on this point, provides rules for the taxation of the contiguous country branch income if it is ever repatriated. First, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g. home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are to be taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec. 482) dealing with reimbursement of costs between related parties are to apply and the domestic company is to establish procdeures for billing the branch at cost. Reimbursements under this provision are not treated as repatriation of income.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company they are to be added to the life insurance company taxable income of the domestic company except to the extent the transfers are reimbursements for home office services. The amount which is to be added to life insurance company taxable income is not to exceed the amount by which the aggregate decrease in life insurance company taxable income for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch exceeds the amount of additions to life insurance company taxable income with respect to that branch which were treated as a repatriation of income for all prior taxable years.

The bill provides that no foreign tax credit (under secs. 901 or 902) is to be allowed with respect to income excluded from life insurance company taxable income by reason of it being accounted for in a contiguous country life insurance branch. In addition, no deduction is to be allowed for these amounts. If amounts are treated as repatriated from a contiguous country life insurance branch it is to be treated for purposes of the foreign tax credit provisions (secs. 78 and 902) as if it was paid as a dividend from a foreign subsidiary. Thus, the gross-up provisions of section 78 are to apply. For purposes of taxation of any income from U.S. sources which is earned by the contiguous country life insurance branch, the branch is treated as a foreign corporation and is subject to tax under the provisions of sections 881, 882 and 1442. Thus, if it derives fixed or determinable annual or periodic income from the United States it is subject to the withholding taxes which apply to foreign corporations. For this purpose the branch is to be entitled to any treaty benefits which it would be entitled to if it were a Canadian subsidiary of a U.S. corporation.

The election provided by this provision may be made for any taxable year beginning after December 31, 1975. Once an election is made it is to remain in effect for all subsequent years except that it may be revoked with the consent of the Secretary. An election, however, may not be made later than the time prescribed by law for filing the return for the taxable year (including extensons thereof) wth respect to which the election is made. Elections and any revocations are to be made in a manner prescribed by the Secretary or his delegate.

Transfers by stock companies.—The committee's amendment also provides a special rule in the case of stock life insurance companies operating in Canada or Mexico. While it is easier for a stock life insurance company to operate through a subsidiary organized under foreign law than it is for a mutual company, problems would be encountered in transferring an existing business to a foreign subsidiary since such a transfer would require the satisfaction of the Secretary that one of its purposes was not the avoidance of Federal incomes taxes. Since the committee amendment contains special rules for deemed transfers in the case of mutual life insurance companies, the committee felt it was appropriate to provide similar rules in the case of actual transfers by stock companies to a contiguous country subsidiary.

Under the committee's amendment a domestic stock life insurance company which has a contiguous country life insurance branch may elect to transfer the assets of that branch to a foreign corporation organized under the laws of that contiguous country without the application of section 367 or 1491. Thus, the excise tax under section 1491 is not to be imposed on the transfer, nor is the Commissioner's approval of the transfer required under section 367.

The insurance contracts which may be transferred to the subsidiary include only those of the types issued by a mutual life insurance company. For this purpose an insurance contract means a life, health, accident or annuity contract or reinsurance contract with respect to these contracts and other types of contracts relating to such contracts. Contracts are to be considered as similar to those issued by a mutual life insurance company if they provide to the policyholder a reduction in premiums similar to the mutual life insurance company's dividend, or retrospective rate credit.

The committee's amendment provides for the taxation of the net gain on the transfer. To the extent that the aggregate fair market value of all the invested assets in tangible property which are separately accounted for in the contiguous country life insurance branch exceeds the aggregate adjusted basis of all of these assets for purposes of determining gain, the domestic life insurance company is to be treated as having sold all of the assets on the first day of the first taxable year for which the election is in effect. The sale will be deemed to have been at the fair market value on that first day and notwithstanding any other provision of Chapter 1 (e.g., sec. 351), the net gain is to be recognized to the domestic life insurance company on the deemed sale. If less than all of the invested assets and tangible property of the contiguous country life insurance branch of the domestic company are transferred, the domestic company will recognize only that part of the net gain which is proportional to the total net gain as the value of the transferred assets is to the value of all such assets.

This provision also provides that the stock of the subsidiary for purposes of determining the income tax of the domestic stock life insurance company is to be given the same treatment as is accorded the assets of a contiguous country branch of a mutual company under the mutual company provision. Similarly, any dividends paid by the subsidiary to the domestic life insurance company will be added to its life insurance company taxable income.

The House bill contains a comparable provision.

Effective date

The amendments made by this section apply to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that the mutual and stock company provisions will result in a decrease in budget receipts of $4 million in fiscal year 1977 and of $8 million thereafter.

9. Transitional Rule for Bond, Etc., Losses of Foreign Banks (sec. 1044 of the bill and sec. 582(c) of the Code)

Present law

The Tax Reform Act of 1969 (Public Law 91–172) eliminated the preferential treatment accorded to certain financial institutions for transactions involving corporate and government bonds and other evidences of indebtedness. Previous to that these financial institutions were allowed to treat net gains from these transactions as capital gains and to deduct the losses as ordinary losses. The 1969 Act (sec. 433, amending sec. 582 of the Code) provided parallel treatment to gains and losses pertaining to these transactions by treating net gains as ordinary income and by continuing the treatment of net losses as ordinary losses. The ordinary income and loss treatment provided under the 1969 Act was also applied to corporations which would be considered banks except for the fact that they are foreign corporations. Previous to the 1969 Act, these corporations had treated the above-described transactions as resulting in either capital gains or capital losses.

Reasons for change

Some of the corporations which would be considered banks except for the fact that they are foreign corporations had capital loss carryovers predating the 1969 Act. However, any post-1969 gains realized by these corporations resulting from the sale or exchange of a bond, debenture, note, or other evidence of indebtedness is accorded ordinary income treatment. Thus, these corporations are left with capital loss carryforwards which, under present law, cannot be applied against any gains resulting from the same type of transactions which previously generated such losses.

Explanation of provision

The committee's amendment provides a special transitional rule for corporations which would be banks except for the fact that they are foreign corporations. Under the amendment, net gains (if any) for a taxable year on sales or exchanges of bonds, debentures, notes, or other evidences of indebtedness are considered as gain from the sale or exchange of a capital asset to the extent that such gain does not exceed the portion of any capital loss carryover to the taxable year where such capital loss is attributable to the same types of sales or exchanges for taxable years beginning before July 12, 1969. In addition, the amendment provides that the refund or credit of any overpayment as a result of the application of the amendment is not precluded by the operation of any law or rule of law (other than section 7122, relating to compromises) so long as the claim for credit or refund is filed within one year after the date of the enactment of the amendment.

The committee's amendment is identical to the House bill.

Effective date

The amendment applies to taxable years beginning after July 11. 1969.

Revenue effect

The revenue loss for the one year period following the date of the enactment of this amendment is estimated to be less than $5 million.

10. Tax Treatment of Corporations Conducting Trade or Business in Possessions of the United States (sec. 1051 of the bill and secs. 33, 931, and 936 of the Code)

Present law

Under present law, corporations operating a trade or business in a possession of the United States are entitled to exclude from gross income all income from sources without the United States, including foreign source income earned outside of the possession in which they conduct business operations, if they meet two conditions. First, 80 percent or more of the gross income of the corporation for the 3-year period immediately preceding the close of the taxable year must be derived from sources within a possession of the United States. Second, 50 percent of the gross income of the corporation for the same 3-year period must be derived from the active conduct of a trade or business within a possession of the United States.

Any dividends from a corporation which satisfies these requirements are not eligible for the intercorporate dividends receive deduction (sec. 246(a) (2) (B)). This deduction, however, is allowed if the corporation did not satisfy these requirements in the current and preceding taxable year. In addition, since corporations meeting the requirements of section 931 are domestic corporations, no gain or loss is recognized to a parent corporation if it liquidates a possessions corporation (under sec. 332). Corporations satisfying the requirements of a possessions corporation and receiving some benefit from the exclusion of income are not entitled to be included in the consolidated return of an affiliated group of corporations (sec. 1504(b) (4)).

The exclusion of possession income applies to corporations conducting business operations in the Commonwealth of Puerto Rico and all possessions of the United States (Guam, the Canal Zone, and Wake Island) except the Virgin Islands. The exclusion also applies to business operations of individuals in a possession, but not to Puerto Rico or to the Virgin Islands and Guam.

Reasons for change

The special exemption provided (under sec. 931) in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, have been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions. Under these investment programs little or no tax is paid to the possessions for a period as long as 10 to 15 years and no tax is paid to the United States as long as no dividends are paid to the parent corporation.

Because no current U.S. tax is imposed on the earnings if they are not repatriated, the amount of income which accumulates over the years from these business activities can be substantial. The amounts which may be allowed to accumulate are often beyond what can be profitably invested within the possession where the business is conducted. As a result, corporations generally invest this income in other possessions or in foreign countries either directly or through possessions banks or other financial institutions. In this way possessions corporations not only avoid U.S. tax on their earnings from businesses conducted in a possession, but also avoid U.S. tax on the income obtained from reinvesting their business earnings abroad.

The committee after studying the problem concluded that it is inappropriate to disturb the existing relationship between the possessions investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries. The U.S. Government imposes upon the possessions various requirements, such as minimum wage requirements [34] and requirements to use U.S. flagships in transporting goods between the United States and various possessions,[35] which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations.

However, investing the business earnings of these possession corporations outside of the possession where the business is being conducted does not contribute significantly to the economy of that possession either by creating new jobs or by providing capital to others to build new plants and equipment. Accordingly, while the committee believes it is appropriate to continue to exempt trade or business income derived in a possession and investment income earned in that possession, your committee does not believe it is appropriate to provide a tax exemption for income from investments outside of the possession.

In addition, the committee recognizes that the provision of present law denying a dividends received deduction to the U.S. parent corporation forces a possessions corporation to invest its income abroad until the possessions corporation is liquidated (usually upon the termination of the local tax exemption) when it can be returned to the United States tax free. These accumulated business profits are not available for investment within the United States, and the income produced is (under present law) not subject to U.S. tax. The committee believes that while it is appropriate to tax the foreign source investment income from possession business earnings, possessions corporations should at the same time be given the alternative of returning the business income to the United States prior to liquidation without paying U.S. tax. Permitting tax-free repatriation of the accumulated earnings only upon the liquidation of the possessions corporation, while taxing the foreign source investment derived from the accumulated earnings, would lessen to a significant extent the tax incentive of making the initial investment.

To accomplish these two major changes, the committee's amendment revises present law to provide for a more efficient system for exemption of possessions corporations. Under the amendment, these corporations are generally to be taxed on worldwide income in a manner similar to that applicable to any other U.S. corporation, but a full 48 percent foreign tax credit is to be given for the business and qualified investment income from possessions regardless of whether or not any tax is in fact paid to the government of the possession. The effect of this revised treatment will be to exempt from tax the income from business activities and qualified investments in the possessions, to allow a dividends received deduction for dividends from a possessions corporation to its U.S. parent corporation, and to tax currently all

[34] 29 U.S.C. 206–208.
[35] 46 U.S.C. 883.

other foreign source income of possessions corporations (with allowance for the usual foreign tax credit). The committee believes that this revised treatment will assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession.

A second set of difficulties under present law results from the relationship of the possessions corporation provisions to the provisions relating to the filing of consolidated tax returns. Domestic corporations which are affiliated (i.e., generally where there is a common ownership of 80 percent or more of their stock) usually file a consolidated tax return. Among the benefits of a consolidated return is the opportunity to offset the losses of one corporation against the income of other corporations.

A corporation which is entitled to the benefits of the special possessions corporation exclusion may not participate in the filing of a consolidated return. However, the courts have determined that possessions corporations may join in filing consolidated returns in years in which they incur losses.[36] As a result, these corporations can in effect gain a double benefit. Not only is the possessions and other foreign source income of these corporations excluded from U.S. taxable income, but losses of possessions corporations can, by filing a consolidated return, reduce U.S. tax on the U.S. income of related corporations in the consolidated group. The committee believes that it is appropriate to allow the losses of a possession corporation to reduce U.S. tax on other income by filing a consolidated return only in the case of initial or start-up losses of possessions corporation just beginning its possession operations. Moreover, even in the case of start-up losses the committee believes that these losses should be recaptured if in a later year foreign source income is derived.

Explanation of provisions

Accordingly, the committee's amendment provides that a possessions corporation must make an election to obtain the benefits of possessions corporation status and that after this election the corporation is ineligible to join in filing a consolidated return for a period of 10 years.[37] Once the election is made the losses of the possessions corporation cannot offset the income of other related corporations. The committee amendment is substantially similar to the House bill.

The amendment achieves the results described above by adding a new provision (sec. 936 of the Code) for the tax treatment of U.S. corporations operating in Puerto Rico and possessions of the United States, other than the Virgin Islands. The existing provision of pres-

[36] The Internal Revenue Service had taken the position that a corporation which meets both of the gross income tests of the possession corporation exclusion provision may not file a consolidated return in years in which that corporation incurred a loss. However, the Tax Court in *Burke Concrete Accessories, Inc.*, (56 T.C. 588 (1971)) held that the possession corporation was properly includable in the consolidated return in these years since it could not be entitled to any benefit from the exclusion provision where it had a loss year. The Internal Revenue Service bas now reversed its position in light of this decision (Rev. Rul. 73–498, 1973–2 C.B. 316).

[37] Unlike the act of incorporating a branch in a foreign jurisdiction, the making of a section 931 election does by itself cause a recapture of an earlier loss.

ent law (sec. 931 of the code) is retained for citizens with business operations in possessions of the United States, other than the Virgin Islands and Guam (but not for citizens with operations in Puerto Rico). The new provision establishes a new tax credit for certain income of possessions corporations. This tax credit (called the section 936 credit) is given in lieu of the ordinary foreign tax credit (provided in sec. 901 of the code).

The amendment provides that any domestic corporation which elects to be a section 936 corporation and which qualifies under section 936 can receive the section 936 tax credit if it satisfies two conditions. First, 80 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year must be from sources within a possession. Second, 50 percent or more of its gross income must be derived from the active conduct of a trade or business within a possession.

The amount of the credit allowed under this provision is to equal the portion of the U.S. tax on the domestic corporation attributable to taxable income from sources without the United States from the active conduct of a trade or business within a possession of the United States and from qualified possession source investment income. In determining the amount of tax attributable to the income from the active conduct of a possession trade or business or from qualified possession investment income, losses from other sources are to be taken into account. For example, if a corporation has an overall loss from foreign sources (other than possessions sources), these losses reduce income from U.S. sources and income from possessions sources proportionately for purposes of determining the tax on the taxable income from which the section 936 credit is allowed.

Qualified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income in that taxable year). It is intended that interest paid by one possessions corporation to a second unrelated possessions corporation is to be treated as qualified possessions source investment income.

Furthermore, the taxpayer must establish to the satisfaction of the Secretary that the funds invested were obtained from the active conduct of a trade or business within that same possession and were actually invested in assets in that possession. Funds placed with an intermediary (such as a bank located in the possession) are to be treated as invested in that possession only if it can be shown that the intermediary did not reinvest the funds outside the possession. The special treatment for qualified possessions source investment income is provided so that the possessions do not lose a significant source of capital which they presently have available to them for the financing of government development programs and private investment.

To avoid a double credit against U.S. taxes if a corporation is eligible for the section 936 credit, any actual taxes paid to a foreign country (because it has different source rules) or a possession with respect to the gross income taken into account for the credit are not treated as a creditable tax (under sec. 901 of the Code), and no deduction is to be allowed with respect to that tax. Thus, the section 936 credit replaces entirely any section 901 foreign tax credit and any deduction for taxes paid which otherwise would be allowed with respect to the income taken into account.

Since the new section 936 tax credit is separate from the tax credit permitted under section 901, the limitation under section 904 of the Code is not to apply to income subject to a section 936 credit, and such income is not to be taken into account in computing the limitation on the amount of allowable tax credits (under sec. 904 of the Code).[38]

The credit provided for under section 936 is generally to be allowed against taxes imposed by chapter 1 of the Internal Revenue Code. However, the credit is not to be taken against any minimum tax for tax preferences (sec. 56 of the Code), any tax on accumulated earnings (sec. 531 of the Code), taxes relating to recoveries of foreign expropriation losses (sec. 1351 of the Code), or the personal holding company tax (sec. 541 of the Code). In computing the amount of U.S. tax paid by the corporation which is attributable to possessions active trade or business and qualified investment income, taxes paid relating to the items described above are not taken into account.

In order to receive the benefits of the section 936 tax credit, a corpporation must make an election at the time and in the manner as the Secretary prescribes by regulations. Once the election is made, the domestic corporation cannot join in a consolidated return with other related taxpayers. The election is to remain in effect for nine taxable years after the first year for which the election was effective and for which the domestic corporation satisfied the 80 percent possession source income and 50 percent active trade or business income requirements. However, the election may be revoked before the expiration of the 10-year period with the consent of the Secretary. It is contemplated that consent will be given only in cases of substantial hardship where no tax avoidance can result from the revocation of the election. In determining whether there would be substantial hardship, the Secretary is to take into account changes in business conditions. The election shall remain in effect after the 10-year period unless such domestic corporation revokes such election. After a revocation the domestic corporation may again make the election for a 10-year period in any taxable year in which it satisfies the 80 percent possession source income and 50 percent active trade or business test.

The amendment retains existing law by providing that any gross income actually received by a possessions corporation within the United States, whether or not that income is derived from sources within or without the United States, is not taken into account as income for which a section 936 tax credit may be allowed. However, this income may be eligible for a section 901 tax credit if any foreign taxes were paid on that income.

Finally, the amendment provides for a dividends-received deduction (sec. 246(a)(1) of the Code) for dividends received from corporations eligible for the section 936 tax credit. Thus, corporations

[38] Thus, the numerator and denominator of the limiting fraction (provvided in sec. 904) are to be calculated without regard to the taxable income for which a credit is permitted under section 936.

which otherwise would qualify for the 100-percent dividends-received deduction if an election (under sec. 936) were not in effect are to receive that deduction for dividends from a possessions corporation. Also, corporations eligible for the 85-percent dividends-received deduction are to receive that deduction with respect to dividends from possessions corporations. In the case of a corporation eligible for the 85-percent dividends-received deduction, the amount of any taxable income received as a dividend from a possessions corporation is to be domestic or foreign source income as determined under existing rules of the Code (sec. 861), and is to be included in the computation of the limitation on the section 901 foreign tax credit (sec. 904 of the Code). Since the 100-percent dividends-received deduction totally eliminates any U.S. tax on dividends paid by a possessions corporation, and the 85 percent dividends-received deduction (after the allocation of expenses) will in many cases eliminate any U.S. tax on the dividend, the committee's amendment adds a provision disallowing a credit or a deduction for any income taxes paid to a possession or foreign country with respect to the repatriation of earnings. Further, the disallowance provision applies in the case of a tax-free liquidation of a possessions corporation.

It is the understanding of the committee that the Department of Treasury is to review operation of section 936 corporations in order to appraise the committee of the effects of the changes made by the bill. The Treasury is to submit an annual report to the committee setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions. These reports, which are to begin with a report for calendar year 1976, are to be submitted to the committee within 18 months following the close of each calendar year.

Effective dates

The amendment made by this section establishing a new section 936 foreign tax credit for certain possessions income applies to taxable years beginning after December 31, 1975. The new rules on the dividends-received deduction apply to dividends received in taxable years beginning after that date regardless of when the earnings out of which the dividends were paid were accumulated.

Revenue effect

It is estimated that these provisions will result in an increase budget receipts of $11 million in fiscal year 1977 and of $10 million thereafter.

11. Western Hemisphere Trade Corporations (sec. 1052 of the bill and secs. 921 and 922 of the Code)

Present law

Under present law, certain domestic corporations called "Western Hemisphere Trade Corporations" (WHTCs) are entitled to a deduction which may reduce their applicable corporate income tax rate by as much as 14 percentage points below the applicable rate for other domestic corporations.[39]

A domestic corporation must meet three basic requirements to qualify as a WHTC. First, all of its business (other than incidental purchases) must be conducted in countries in North, Central or South America or in the West Indies. Second, the corporation must derive at least 95 percent of its gross income for the 3-year period immediately preceding the close of the taxable year from sources outside the United States. Third, at least 90 percent of the corporation's income for the above period must be derived from the active conduct of a trade or business. The above requirements are intended to insure that the corporation is engaged in an active trade or business outside the United States, but within the Western Hemisphere.

Reasons for change

The WHTC provisions were originally enacted in 1942 during a period of high U.S. wartime taxes and generally low taxes in other Western Hemisphere countries. The provision was aimed at insuring that domestic corporations did not operate at a disadvantage in competing with foreign corporations within the Western Hemisphere. While not explicitly stated, it appears that the goal was to retain U.S. ownership of foreign investments, which if placed in a foreign corporation, might end up being owned by foreign interests.

Your committee believes general tax equity requires that income derived from all foreign sources be taxed at the same rate. To the extent that incentivs are needed for the export of U.S. manufactured goods the committee believes that the Domestic International Sale Corporation (DISC) provisions of present law are a more appropriate incentive. Further, because the taxes imposed by other Western Hemisphere countries have been substantially increased since the original enactment of the provision, many companies which qualify as WHTCs receive little or no benefit from the deduction. Thus, in many instances the WHTC deduction merely adds to the complexity of preparing an income tax return without providing significant tax benefits.

The preferential rate granted to WHTCs has also encouraged U.S. manufacturers to set the price on sales of goods to related WHTCs so as to maximize the income derived by the WHTC, since this income is taxed at the lower WHTC rate. These pricing practices have been the source of many controversies between taxpayers and the Internal Revenue Service. Finally, the broad interpretation given to the WHTC provisions by the Internal Revenue Service has enabled corporations to obtain the benefits of the WHTC provisions for goods manufactured outside the Western Hemisphere by causing the title to the goods which are sold to the WHTC to be passed within the Western Hemisphere. In such a situation your committee believes it is inappropriate to give special tax relief. For the above reasons your committee believes that the special tax relief given to WHTCs should be repealed.

Explanation of provision

The committee's amendment repeals the WHTC provisions for taxable years beginning after December 31, 1979. However, corporations

[39] The deduction (sec. 922 of the Code) is equal to taxable income multiplied by 14 over the corporate tax and surtax rates

which qualify for WHTC treatment are provided a transitional period in which they can adjust their operations to the repeal of the provisions. During this transitional period the 14-percent tax reduction (*i.e.*, the numerator in the 14/48ths fraction) is gradually phased out beginning in 1976. Under the phaseout rules the percentage rate reduction is reduced to 11 percent in 1976, 8 percent in 1977, 5 percent in 1978 and 2 percent in 1979. Corporations which presently do not qualify for WHTC treatment are able to qualify and receive the remaining benefits of the treatment during the transitional period. Thus, during the phaseout period no distinction is to be made between corporations qualifying for WHTC treatment in 1975 and other corporations which first qualify during the phaseout period. It is anticipated by your committee that the modifications which it is making to the provisions of section 367 will make it easier for domestic corporations to adjust to the repeal of the WHTC provision in order to retain tax advantages provided by the tax laws of foreign governments, by reincorporating in a foreign country where they are doing business. An identical phaseout provision is in the House bill.

In addition, the committee amendment provides a special transitional rule for WHTCs which file as part of a consolidated group using the per-country limitation. Prior to the repeal of the per-country limitation, a WHTC which used the per-country limitation could average its foreign taxes and income with a non-WHTC if they both derived their income from the same country. However, the averaging of foreign taxes and income of WHTCs and non-WHTCs is not allowed under the overall limitation except in the case of a public utility. The committee amendment permits a foreign corporation which is treated as being a domestic company for consolidated return purposes to average its foreign taxes with other corporations in the group if they each derive 95 percent or more of their gross income from sources within a contiguous country and are primarily engaged in mining and related transportation in that contiguous country.

Effective date

The effective date of this provision is discussed above under explanation of provision.

Revenue effect

This provision will increase budget receipts by $16 million in fiscal year 1977, $25 million in fiscal year 1978, and $50 million in fiscal year 1981.

12. China Trade Act Corporations (sec. 1053 of the bill and secs. 941 to 943 of the Code)

Present law

Under present law, a China Trade Act Corporation ("CTA corporation") and its shareholders are entitled to special tax benefits. Under these provisions, a CTA corporation is subject to the same tax rates as any other domestic corporation, but, upon meeting certain requirements, is allowed a special deduction which can completely eliminate any income subject to tax (sec. 941).[40]

[40] The CTA corporation is not entitled to the foreign tax credit (sec. 942), but is entitled to the deduction of all foreign taxes paid with respect to taxable income derived from sources within Hong Kong or Formosa (sec. 164).

The special deduction is allowed against taxable income derived from sources within Formosa and Hong Kong in the proportion which the par value of stock held by residents of Formosa, Hong Kong, the United States, or by individual citizens of the United States, wherever resident, bears to the par value of all outstanding stock. Thus, where all the shareholders of the CTA corporation are either U.S. citizens or residents of Hong Kong, Formosa, or the United States, and all of the corporation's income is derived from sources within Hong Kong and Formosa, the special deduction equals and thereby eliminates the taxable income of the corporation.

The special deduction is limited by a requirement that a dividend must be paid in an amount at least equal to the amount of Federal tax that would be due were it not for the special deduction. The "special dividend" must be paid to stockholders who, on the last day of the taxable year, were resident in Formosa, Hong Kong, or were either residents or citizens of the United States.[41] The special dividend deduction enables the CTA corporation to operate free of tax.

In addition to the favorable tax treatment at the corporate level, special benefits are accorded to the shareholders of a CTA corporation. Dividends paid by a CTA corporation to shareholders who reside in Hong Kong or Formosa are not includable in the gross income of the shareholder (sec. 943). This applies to all dividends paid to Hong Kong or Formosa resident shareholders, regardless of whether they are regular or special dividends.

Reasons for change

The combination of benefits granted to CTA corporations and their shareholders is unprecedented.[42] Both the corporation and its shareholders can operate free of any U.S. tax liability.

As originally enacted, the China Trade Act was intended to apply to mainland China, including Manchuria, Tibet, Mongolia, and any territory leased by China to any foreign government, the Crown Colony of Hong Kong, and the Province of Macao. However, since the early 1950's the provisions have only applied to business transactions by CTA corporations in Hong Kong and Formosa.

Since the enactment of the China Trade Act in 1922, Sino-U.S. trade has changed dramatically. In 1922, China was considered an unequal trade partner—a market which Western companies competed for under rules that were laid down by their own governments, not by the Chinese Government. Prior to the Communist occupation of the China mainland in 1949, approximately 250 companies were con-

[41] For example, if the taxable income before the special deduction was $100,000, the special dividend would have to equal at least $41,500 (22 percent of the first $25,000 plus 48 percent of the remaining $75,000). In this example, upon payment of the special dividend of $41,500, the CTA corporation deriving all of its taxable income from sources within Hong Kong and Formosa ($100,000) would be entitled to a special deduction in an amount equal to its taxable income, i.e., $100,000.

[42] For example if in a given year, a CTA corporation, whose shareholders are U.S. citizens residing in Hong Kong or Formosa, has $500,000 of taxable income and pays a special dividend of at least $233,500 to its shareholders, neither the corporation nor its shareholders will incur any U.S. tax liability, whereas a domestic corporation and its shareholders in this situation (assuming marginal tax brackets of 50 percent for the shareholders) would incur respective U.S. tax liabilities of $233,500 and $116,750. The tax savings to the CTA corporation and its shareholders in the above example would be $350,250. If the balance of the earnings of the CTA corporation were paid out, the tax savings would be even greater.

ducting business there under the China Trade Act. This situation no longer exists, trade being restricted now to Hong Kong and Formosa; nor is it likely to exist in the foreseeable future. Currently, there are only three active CTA corporations, which reportedly account for a rather negligible amount of trade.

Thus, the original purpose of the China Trade Act, that of expanding trade with China, is no longer being served by the very favorable tax advantages it provides. Moreover, there are innumerable U.S. companies currently trading in Hong Kong and Formosa without the extensive tax benefits provided by the China Trade Act.

The tax advantages enjoyed by a CTA corporation, and particularly its shareholders, are almost without parallel. While, under present law, there are cases where U.S. tax would not be owing with respect to corporate income derived by a foreign subsidiary involved in an active trade or business abroad, dividend payments received from such corporations by U.S. shareholders would be subject to U.S. taxation. There is no current justification for exempting CTA corporation dividends paid to its Hong Kong and Formosa resident shareholders who are U.S. citizens.

Explanation of provision

The committee's amendment provides for a phaseout over a 2-year period of the provisions permitting special tax treatment for CTA corporations and their shareholders. Thus, the special deduction allowable under section 941(a) and the dividend exclusion under section 943 will be reduced by 50 percent for taxable years beginning in 1976, and repealed for taxable years beginning in 1977.[43]

The House bill phased out the provisions over a 4-year period.

Effective date

The effective date of this provision is discussed above under Explanation of provision.

Revenue effect

This provision is expected to increase receipts by less than $5 million per year.

13. Amendments Denying Tax Benefits on International Boycott Income and Foreign Bribe-Produced Income (secs. 1061–1066 of the bill and secs. 908, 911, 952, 955A, 995, and 999 of the Code)

Present law

Under present law U.S. taxpayers conducting business abroad are not subject to special penalties with respect to the conduct of their business operations. Present law does provide, however, that illegal payments made to a government official are not deductible as an ordinary business expense. These rules are applicable as well to payments made to foreign government officials.

[43] For example. if the taxable income before the special deduction of a CTA corporation was $100.000 and the special dividend was $41.500, the special deduction for the corporation and the amount of dividend excludible from income for taxable years beginning in 1976 would be $50.000 and $20.750. respectively. For taxable years beginning in 1977 and subsequent years. the CTA provisions are repealed and no special deduction nor dividend exclusion would be available.

Under present law U.S. taxpayers operating abroad receive a number of benefits or incentives which enable them to compete with foreign-owned business or to increase the export of U.S.-made goods. The four major tax provisions which are significant in connection with overseas operations are (1) the foreign tax credit for foreign taxes paid, (2) the deferral of earnings of foreign subsidiaries, (3) the deferral of earnings of domestic international sales corporations, and (4) the earned income exclusion for U.S. citizens working overseas.

Reasons for change

The committee is concerned that U.S. business has been prevented from freely operating in international markets by the threat of economic sanctions by certain foreign countries or their employees. Unless the U.S. business agrees to cooperate or participate with certain foreign countries in an international boycott based upon nationality or religion, they are denied the opportunity to conduct business with a country. It is particularly unfair in the committee's belief, when the taxpayer who participates in the boycott is a recipient of tax preferences by reason of the participation. The committee believes that many taxpayers would not participate in an international boycott if the taxpayer and the foreign countries were made aware that tax preferences were not available to a taxpayer who participates in such a boycott.

In addition to the concern over international boycotts, recent revelations have disclosed the use of foreign bribes as a means of doing business overseas. The committee believes that the tax preferences which are granted to taxpayers in connection with overseas operations should not be allowed in connection with bribe-produced income.

The committee believes that these four tax benefits in connection with overseas operations should not be made available in countries in which a U.S. taxpayer has participated in an international boycott. In addition these benefits should not be made available in connection with bribe-produced income. However, since the employees' earned income exclusion is not directly connected to the employer's bribe the employee should not be penalized if the employer makes an illegal payment.

Explanation of provisions

Denial of foreign tax credit.—The committee's amendment adds a new section 908 to the Code. The effect of the new section is to deny the foreign tax credit with respect to certain taxes paid or accrued to any country which requires participation in or cooperation with an international boycott, and with respect to certain taxes paid or accrued to any foreign country on income derived as a result of the making of an illegal bribe, kickback, or other unlawful payment to the foreign government.

The committee's amendment provides that a taxpayer who participates in or cooperates with an international boycott may not elect to credit against U.S. taxes any income, war profits, or excess profits taxes paid or accrued during the taxable year to any country which requires participation in. or cooperation with, the boycott as a condition of doing business within that country or with the government, a company, or a national of that country. The amendment also provides that if a taxpayer makes an illegal bribe, kickback, or other unlawful payment, directly or indirectly, to an official, employee, or agent in fact of a foreign government, the taxpayer may not elect the foreign tax credit with respect to income, war profits, or excess profits taxes paid or accrued during the taxable year to any country with respect to income derived directly or indirectly, in whole or in part, as a result of the making of such payments. (Any disallowed taxes would not be allowed as a deduction in the case of bribe-produced income.)

If it is determined by the Secretary of Treasury that the taxpayer has participated in a boycott with a foreign country, all foreign taxes paid to that country are not allowed as creditable taxes. On the other hand, if it is determined that a taxpayer has bribe-produced income from a country, only foreign taxes paid with respect to that income (regardless of the year derived) are disallowed.

Denial of deferral.—The committe's amendment eliminates deferral of the income tax for U.S. shareholders of controlled foreign corporations with respect to certain income derived from operations in or related to any country which requires participation in, or cooperation with, an international boycott, and with respect to certain income derived as a result of the making of an illegal bribe, kickback, or other unlawful payment to certain officials, employees, or agents of a foreign government.

The committee's amendment creates two new classes of subpart F income. These new categories of subpart F income are "international boycott income" and "foreign bribe-produced income". Under the committee's amendment, a U.S. shareholder of a controlled foreign corporation must include in income his pro rata share of the controlled foreign corporation's international boycott income and foreign bribe-produced income.

International boycott income is defined as all the income of a controlled foreign corporation (other than income derived from the insurance of U.S. risks and foreign base company income) which is derived from operations in or related to any foreign country which requires participation in or cooperation with an international boycott as a condition of doing business within that country or with the government, a company, or a national of that country. Income is international boycott income only if the controlled foreign corporation (or a member of a controlled group which includes the controlled foreign corporation) is determined to have participated in or cooperated with the international boycott in that year. As discussed under the heading of reporting requirements and determinations. the committee amendment authorizes the Secretary to determine whether or not there has been participation in, or cooperation with, a international boycott.

Foreign bribe-produced income is defined as all the income of a controlled foreign corporation (other than income derived from the insurance of United States risks, foreign base company income and international boycott income) which is derived, directly or indirectly, in whole or in part, as the result of the making of an illegal bribe, kickback, or other unlawful payment, either directly or indirectly, to an official, employee, or agent in fact of a foreign government by the controlled foreign corporation or any member of a controlled group which includes the controlled foreign corporation involved regardless of the year in which the payment is made. Both international boycott income and foreign bribe-produced income are to be reduced, under regulations prescribed by the Secretary, to take into account deductions properly allocable to such income.

Denial of DISC benefit.—The committee amendment provides that if a DISC, or a member of a controlled group which includes the DISC, has participated in or cooperated with an international boycott, or has received foreign bribe-produced income, no DISC benefits are to be allowed. The entire taxable income of the DISC which is attributable to international boycott income or foreign bribe-produced income is deemed to be distributed to the DISC shareholder.

The committee amendment provides that DISC benefits are to be denied with respect to international boycott income and the foreign bribe-produced income of a DISC, realized in one taxable year which is derived directly or indirectly, in whole or in part, as a result of participation in, or cooperation with, an international boycott, or the making of an illegal bribe, kickback, or other unlawful payment, in a different taxable year.

Denial of exemption for earned income abroad.—The committee amendment eliminates the exemption for earned income abroad for certain U.S. citizens who are bona fide residents of foreign countries or are physically present abroad for 510 days during any 18-month period. The exemptions are denied with respect to the earned income derived from any person who participates in, or cooperates with, an international boycott as a condition of doing business within or with a foreign country. The exemptions are only denied, however, with respect to earned income for personal services rendered in the foreign country or countries requiring participation in or cooperation with the international boycott.

Reporting requirements and determinations.—The committee's amendment adds a new section 999 to the Code requiring certain reports to be made by taxpayers with respect to income which is potentially international boycott income or foreign bribe-produced income, and authorizing the Secretary to determine whether a taxpayer has international boycott income or foreign bribe-produced income.

Any taxpayer who has income (or is a member of a controlled group which has income) which is derived, directly or indirectly, from operations in, or related to, a foreign country which requires participation in, or cooperation with, an international boycott as a condition of doing business within such country, or with the government, a company, or a national of such country, must report (pursuant to regulations to be prescribed by the Secretary) the fact that it has income derived from these operations and the amount of the income. Also any taxpayer who has income (or is a member of a controlled group which has income) which is derived, directly or indirectly, in whole or in part, as the result of the making of an illegal bribe, kickback, or other unlawful payment to an official, employee, or agent in fact of a foreign government, must report (pursuant to regulations to be prescribed by the Secretary) the amount of such payments and the amount of the income derived from the payments.

Criminal penalties are imposed on the willful failure to make the required reports. The penalties consist of a fine of not more than $25,000, or imprisonment for not more than 1 year, or both.

The committee amendment also authorizes the Secretary, upon receipt of the required reports, to determine whether the taxpayer (or member of the controlled group which includes the taxpayer) participated in, or cooperated with, an international boycott or has foreign bribe-produced income. Participation in, or cooperation with, an international boycott includes, as a condition of doing business within a country or with the government, a company, or national of a country, agreeing to:

(1) Refrain from doing business in another country or with the government, companies, or nationals of another country;

(2) Refrain from doing business with any United States person engaged in trade in another country or with the government, companies, or nationals of another country; or

(3) Refrain from doing business with any company whose ownership or management is made up, all of in part, of individuals of a particular nationality or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality or religion.

Participation in, or cooperation with, an international boycott also includes, as a condition of sale of a product to the government, a company, or a national of a country, agreeing to ship or insure such product only on a carrier which is not on an international boycott list. A taxpayer or a member of a controlled group is not considered as participating in or cooperating with an international boycott if participation in, or cooperation with, such boycott is required by U.S. law.

There are no comparable provisions in the House bill.

Effective date

The amendments made by these provisions apply to taxable years beginning after December 31, 1975, except that the amendments relating to denial of deferral of income by U.S. shareholders of controlled foreign corporations shall apply to taxable years of the controlled foreign corporation beginning after December 31, 1975, and to taxable years of U.S. shareholders (within the meaning of section 951(b) of the Code) within which or with which such taxable years of such foreign corporations end. However, the amendment only applies to any participation in, or cooperation with, an international boycott or an illegal payment made, 30 days after the date of enactment.

Revenue effect

It is estimated the provisions relating to international boycott and foreign bribes will increase budget receipts by $100 million in fiscal year 1977 and thereafter.

K. DOMESTIC INTERNATIONAL SALES CORPORATIONS (sec. 1161 of the Bill and secs. 993, 995, and 996 of the Code)

Present law

Present law provides for a system of tax deferral for a corporation known as a Domestic International Sales Corporation, or a "DISC", and its shareholders. Under this tax system, the profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed to them. However, each year a DISC is deemed to have distributed income representing 50 percent of its profits, thereby subjecting that income to current taxation in the shareholders' hands. In this way the tax deferral which is available under the DISC provisions is limited to 50 percent of the export income of the DISC.

To qualify as a DISC, at least 95 percent of the corporation's assets must be export-related and at least 95 percent of a corporation's gross income must arise from export sale or lease transactions and other export-related activities (i.e., qualified export receipts). Qualified export receipts include receipts from the sale of export property, which generally means property such as inventory manufactured or produced in the United States and held for sale for direct use, consumption or disposition outside the United States (or to an unrelated DISC for such a purpose). The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. However, energy resources, such as oil and gas and depletable minerals, are automatically denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which are prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity.

If a DISC fails to meet the qualifications for any reason (including legislation excluding the corporations' products from export property), the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. This recapture is spread out over the number of years for which the corporation was qualified as a DISC but may not exceed 10 years. In addition, the DISC provisions provide for recapture of the DISC benefits if the stock of the DISC is sold or exchanged.

Reasons for change

The committee has examined the DISC provisions at great length and has concluded that the legislation has had a beneficial impact on U.S. exports. Since 1971, when DISC was enacted, exports have increased from $43 billion to $107 billion for 1975. It is clear that much of this increase has resulted from the devaluation of the dollar which has taken place since that period. Nonetheless, the committee concluded that a significant portion of the increase in exports which has taken place resulted from the DISC legislation. This increase in exports, the committee concluded, provides jobs for U.S. workers and helps the U.S. balance of payments.

However, the committee also recognized that questions have been raised as to the revenue cost of the DISC program. In 1975, the program is expected to cost nearly $1.3 billion and in 1976 the amount is estimated to be $1.4 billion. Furthermore, the committee believes that the DISC legislation is made less efficient because the benefits apply to all exports of a company, regardless of whether or not a company's products would be sold in similar amounts without export incentive and regardless of whether or not the company is increasing or decreasing its exports.

Given these considerations the committee concluded that the DISC program could become more efficient and less costly while still providing the same incentive for increased exports and jobs by granting DISC benefits only to the extent that a company increases its exports over a base period amount and by excluding from DISC benefits certain products and commodities for which the committee believes that no incentive is needed for export sales. The House bill contains a comparable incremental rule; in addition, the House bill repeals DISC benefits for almost all agricultural and military products.

Explanation of provisions

Incremental computation of DISC benefits.—Under the committee's amendment, the tax deferral benefits provided to a DISC and its shareholders are to be computed on an incremental basis. However, the basic structure of the DISC provisions of present law are continued. DISCs continue not to be taxable entities themselves, but certain amounts of the taxable income of the DISCs are deemed distributed to the shareholders of the DISCs and taxed to them. Furthermore, the requirements for qualifying as a DISC are to remain the same, as are the intercompany pricing rules and most of the technical provisions of the DISC provisions.

Deemed distribution.—The committee's amendment provides for the incremental computation of DISC benefits by adding a new category of deemed distributions from a DISC to its shareholders. The amount of this new deemed distribution is the adjusted taxable income for the current taxable year which is attributable to adjusted base period export gross receipts (i.e, the nonincremental portion of the current year's export receipts). These amounts are to be deemed distributed to the shareholder prior to the computation of the deemed distribution (provided under present law) equal to one-half of the taxable income of the DISC. That is, adjusted taxable income attributable to adjusted base period export gross receipts is to be deemed distributed first, and then one-half of remaining taxable income of the DISC is to be deemed distributed. For example, if a DISC had taxable income of $100 and taxable income attributable to the adjusted base period export gross receipts of $30, the deemed distributions for the year would be $65 ($30+½($100−$30)). Thus, a deferral of tax would be permitted on $35.

Adjusted taxable income is the taxable income of the DISC in the current year reduced by producer's loan interest and gain on the sale of certain property of the DISC. These amounts are deemed distributions from a DISC to its shareholders under current law.

The amount deemed distributed is that portion of the current year's adjusted taxable income which is attributable to the current year's export gross receipts not in excess of the base period exports.[44] For example, if adjusted base period export gross receipts were $100 and the current year's export gross receipts were $300, one-third of the adjusted taxable income of the DISC in the current year would be treated as attributable to adjusted base period export gross receipts and be a deemed distribution for the current year.

The committee's amendment defines adjusted base period export gross receipts as 60 percent of the average of the export gross receipts of a DISC during the base period.

The base period consists of taxable years beginning in 3 of the 4 base period years chosen by the DISC, except that, in the case of agricultural products, it is 3 of the 5 base period years chosen by the DISC. The choice of base period years prevents distortion due to the existence of very high export gross receipts in one taxable year. Since this problem is especially acute with respect to agricultural products, the committee amendment permits a choice of 3 out of 5 base period years.

The committee amendment defines agricultural products to include agricultural and horticultural commodities and products. Generally, this includes all products or commodities which are grown or raised. The bill specifically includes in these categories livestock, timber, poultry, fish, and fur-bearing animals.

Whether or not a product made from an agricultural or horticultural commodity or product is included within this provision is to be determined by applying the 50 percent value-added test which exists in present law with respect to the elimination of DISC benefits for certain natural resources (sec. 993(c)(2)). Under this test, if 50 percent of the value added to the product as exported is attributable to manufacturing and processing, then the product is not to be considered an agricultural or horticultural commodity or product and is to retain DISC benefits. As under existing law, the term "processing" does not include extracting or handling, packing, packaging, grading, storing, or transporting.

Export gross receipts.—The term "export gross receipts" includes those receipts which are received in the ordinary course of the export trade or business of the DISC in which the DISC derives its income (see sec. 993(a)). For this reason, the term includes income from the sale, exchange, or rental (and related subsidiary services) of export property (as defined in sec. 993(c)) for consumption outside of the United States; engineering and architectural services for projects outside the United States; and the performance of managerial services for a DISC which relate to the sale, exchange, rental or other disposition of export property. However, the term does not include gross

[44] The deemed distribution is computed by taking the ratio of adjusted base period export gross receipts to current year's export gross receipts and multiplying it by the adjusted current year's taxable income of the DISC.

receipts from the sale, exchange or other disposition of qualified export assets (under sec. 993(b)) other than export property (i.e., assets such as warehouses and packaging machines which generally are used in the export business but which are not sold in the ordinary course of business); dividends or deemed distributions (under subpart F) from a related foreign export corporation (as defined in sec. 993(e)); and interest on any obligation (such as Export-Import Bank obligations) which is a qualified export asset.

Base period years.—Under the committee's amendment, the base period for nonagricultural products is composed of taxable years beginning in 3 out of 4 base period years chosen by the DISC. For taxable years beginning in 1977, 1978, and 1979 the base period years are taxable years beginning in 1973, 1974, 1975, and 1976. In taxable years beginning in 1980 and later years, the base period becomes a 4-year moving base period. The base period is to move forward 1 year for each year beyond 1979, so that the base period years for any year is the taxable year beginning in the 3d, 4th, 5th, and 6th calendar years preceding such calendar year. For example, in 1980, the base period years are 1974, 1975, 1976, and 1977 and in 1981, the base period years are 1975, 1976, 1977, and 1978.

For agricultural products the incremental rule does not apply to taxable years beginning prior to 1980. In 1980 and thereafter, the base period is composed of taxable years beginning in 3 out of 5 base period years chosen by the DISC. For taxable years beginning in 1980, the base period years are 1973, 1974, 1975, 1976, and 1977. In taxable years beginning in 1981 and later years, the base period becomes a 5-year moving base period. The base period is to move forward 1 year for each year beyond 1980, so that the base period years for any year is the taxable year beginning in the 3d, 4th, 5th, 6th, and 7th calendar years preceding such calendar year. For example, in 1981, the base period years shall be 1974, 1975, 1976, 1977, and 1978 and in 1982, the base period years shall be 1975, 1976, 1977, 1978, and 1979.

The average export gross receipts for the base period is the sum of the export gross receipts for the 3 base period years chosen by the DISC, divided by 3. The DISC may choose any 3 base years that it desires in a given taxable year. If the taxpayer did not have a DISC in any year which would be included in the base period for the current year, the taxpayer is to calculate base period export gross receipts by attributing a zero amount of export gross receipts to that base period year except that if the DISC has 3 base vears in which it is in existence, it must choose those 3 base years rather than choose a year in which it was not in existence. For example, in the case of a nonagricultural DISC which was not in existence in1973 and 1974, but had $25 of export gross receipts in 1975, and $35 in 1976, the base period for taxable year 1978 is to include base period years 1975 and 1976. Thus, the base period export gross receipts of the DISC would be ($0+$25+$35) divided by 3 or $20. Sixty percent of this average, or $12, would be the adjusted base period export gross receipts of the DISC.

Because base period years in which a DISC was not in existence are included as zero base period years under these provisions, DISCs beginning operation in 1977 have no base period export gross receipts for

3 full years (until 1980), when the base period begins to include a year in which the DISC had export gross receipts. In 1980 its base period export gross receipts would be its 1977 export gross receipts divided by 3. The DISC would thus first have a full 3-year base period in 1982.

Short taxable years.—In the case of a taxpayer having a short taxable year in the base period, the Secretary is to prescribe regulations including the annualization, if necessary, of export gross receipts in the short base period taxable year or years in determining base period export gross receipts. Similar regulations are to be prescribed if the current year is a short year in order to compute the deemed distribution. It is intended that under these regulations short taxable years in the base period will generally be annualized for purposes of determining base period export gross receipts so that the amount of the increase in current year export gross receipts is based on an equivalent full year amount of export gross receipts in each base period year. Similarly, in cases where the current year is a short taxable year, it is intended that export gross receipts in the current year will generally be expanded proportionately by the ratio of the length of the short taxable year to a full taxable year. Of course, this adjustment is only to affect the computation of export gross receipts to be used in determining the amount of the current year's taxable income which is attributable to base period export gross receipts. The adjustment is not to affect the amount of taxable income of the DISC for the current taxable year or the amount of accumulated DISC benefits from any base period year.

Adjustments to base period.—The committee amendment includes three special rules to deal with situations where a corporation has an interest in more than one DISC, or where a DISC and the underlying trade or business giving rise to the DISC income have been separated. The purposes of these rules are, first, to insure that in every year the base period export gross receipts which are attributable to a DISC for purposes of deemed distributions in the current year are appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or trading DISCs, to reduce deemed distributions attributable to base period export gross receipts.

Controlled group.—The committee amendment provides that if one or more members of a controlled group of corporations (as defined in sec. 993(a)(3) to include all corporations with 50 percent or more common ownership) qualify as a DISC in the current or base period years, the amount deemed distributed as taxable income attributable to adjusted base period export gross receipts to the common shareholder of the DISCs (and the adjusted taxable income for purposes of the small DISC rule) is to be determined by aggregating taxable income, current year export gross receipts, and base period export gross receipts of the commonly owned DISCs. This aggregation is to be accomplished under regulations prescribed by the Secretary and is to be reflected on a pro rata basis (i.e., according to taxable income) in each DISC for purposes of determining the deemed distribution from each DISC. The Secretary's regulations thus are not intended to require aggregation of commonly owned DISCs for all purposes (including for purposes of meeting the qualifications of a DISC). Rather, this aggregation is to be required only to the extent necessary so that a taxpayer which exports through more than one related DISC (in the current year or the base period), cannot gain any advantage by increasing its exports in one DISC or the other, since the base period of both DISCs are taken into account in determining the amount of the deemed distribution of taxable income attributable to base period export gross receipts. In determining base period export receipts for this purpose, commonly owned DISCs are to use the same 3 base years during the base period. It is intended that in cases where two DISCs are members of a controlled group, but where an unrelated person owns some stock in one of the DISCs, the aggregation rule does apply in computing any deemed distribution to that shareholder.

Separation of DISC and its trade or business.—A second special rule is provided for situations where the ownership of a DISC and the underlying trade or business which gives rise to the export gross receipts of the DISC are separated. This could arise through the sale of the underlying trade or business or through a tax-free reorganization in which the DISC and the underlying trade or business are separated. The special rule requires that a person owning the underlying trade or business during the taxable years after the separation of the trade or business from the DISC be treated as having, in any DISC in which the owner of the trade or business has an interest, an amount of additional export gross receipts for base period years equal to export gross receipts in base period years of the DISC attributable to that trade or business.

The effect of this provision is to provide a double attribution of base period export gross receipts in cases where a DISC is separated from the underlying trade or business through a tax-free reorganization or through a sale of the underlying trade or business. In these cases the base period export gross receipts of the DISC also remain with the DISC and are to be taken into account by the shareholders of the DISC (whether or not the DISC has acquired new shareholders in a tax-free reorganization) in computing adjusted base period export gross receipts of the DISC for years prior to the reorganization or sale.[45]

Since, under present law, in the case of a sale or disqualification of a DISC, the DISC benefits for prior years are recaptured, export gross receipts for base period years prior to any sale (or disqualification) are to be reduced on a pro rata basis to the extent of the recapture. For example, if a DISC which was disqualified was entitled to defer $100 of accumulated DISC income, $40 of which was recaptured, the export gross receipts for the base period years are to be reduced by 40 percent.

A separation of the DISC and the underlying trade or business does not occur if the DISC and the trade or business which gave rise to the base period export gross receipts of the DISC are owned

[45] For example, if a DISC alone is transferred in a section 355 spin-off transaction, the shareholders of the DISC after the transfer will in computing any deemed distributions, take into account the adjusted base period export gross receipts for all base years of the DISC, including years prior to the section 355 transaction. In addition, the owners of the trade or business from which the DISC is spun off will also be treated as having base period export gross receipts equal to the amount of the base period export gross receipts of the DISC which was spun off. These amounts are to be added to any base period export gross receipts which may exist in any DISC in which the owners of the trade or business have an interest or subsequently obtain an interest.

throughout current taxable year by members of the same controlled group, but only to the extent that the ownership of the DISC and the trade or business is proportionate during all of the current taxable year (i.e., the taxpayer owns the same proportionate amount of stock in the DISC as it owns in the trade or business during the current year). As a result, in cases where a DISC is transferred at the same time that the underlying trade or business is transferred (either by sale or tax-free reorganization), the double attribution of the base period export gross receipts of the DISC does not apply. The intent of these provisions is to prevent taxpayers from separating a DISC from the underlying trade or business giving rise to the export gross receipts of the DISC in order to reduce base period export gross receipts.

Shareholders of two or more unrelated DISCs.—A final special rule is provided to apply to situations where a person owns a partial interest in a DISC (i.e., 5 percent or more of the stock of a DISC). Under this rule, if a person has had an interest in more than one DISC (either simultaneous ownership or ownership of one DISC during the base period and ownership of the second DISC during the current year), then, to the extent provided in regulations prescribed by the Secretary to prevent circumvention of the rules for deemed distributions of taxable income attributable to adjusted base period export gross receipts, amounts equal to that shareholder's pro rata portion of the base period export gross receipts of DISCs owned during the base period are to be included in base period export gross receipts of DISCs currently owned by the shareholder. This provision is intended to give the Commissioner general authority to prevent situations where, by having an interest in more than one DISC, a taxpayer could artificially reduce the base period export gross receipts that would otherwise be attributable to a currently active DISC in order to obtain a smaller deemed distribution in the current year.

Where the provisions of the first two special rules are applied, it is contemplated that generally the rules regarding deemed distributions will not have been circumvented, and thus no further adjustment of base period export gross receipts is to be required. Further, it is intended that this provision will generally not be applied in cases where a taxpayer has sold all the shares he held in any DISC, since the amount of benefits received from that DISC will have been recaptured. However, the Secretary is to have authority to attribute base period gross receipts to more than one DISC in cases of separations and acquisitions of DISCs from underlying trades or businesses if such double attribution is consistent with the purposes of the special rules of the bill and is appropriate to eliminate any incentive to separate DISC assets from their underlying trades or businesses.

Small DISCs exception.—The bill exempts small DISCs from the new incremental rules. Under the bill, DISCs with adjusted taxable income in the current taxable year of $100,000 or less are not subject to the new incremental rules. Instead, these DICSs will continue to receive the full DISC benefits provided under existing law. The exception is phased-out on a 2-for-1 basis so that DISCs with taxable income of $150,000 or more receive no benefit.

DISCs with taxable income of over $100,000 for a taxable year are to be treated as having made deemed distributions equal to the amount of their adjusted base period gross export receipts, but this amount is first to be reduced by twice the excess (if any) of the $150,000 over the DISC's adjusted taxable income. The effect of this provision is to phase out the special treatment for small DISCs on a 2-for-1 basis, so that DISCs with adjusted taxable income of $150,000 or more receive no benefit from the rule and DISCs with adjusted taxable income between $100,000 and $150,000 will lose $2 out of the $100,000 exemption for each $1 of adjusted taxable income beyond $100,000.[46]

For purposes of this special rule for small DISCs, adjusted taxable income means the taxable income of the DISC not including interest on producer's loans or gain on the sale or exchange of property by the DISC, which gain is attributable to any unrecognized gain of any person which transferred the property (in a nonrecognition transaction) to the DISC. These amounts are automatically deemed distributed to the shareholder of a DISC under present law, and thus should not affect the taxable income of the DISC for this purpose.

Termination of DISC benefits for military goods.—The Committee amendment terminates DISC benefits for certain military goods when there is no competition with foreign-made military goods. Military goods are defined as any property which, at the time of sale, is considered to be "arms, ammunition, or implement of war" and is designated as such in the munitions lists published by the Secretary of State pursuant to the Mutual Security Act of 1954 (22 U.S.C. 1934) regardless of whether they are exported for military or civilian use. However, if a determination is made by the Secretary of Treasury (after consultation with the Secretary of Defense) that the property to be exported is competitive with foreign manufactured products the export will be eligible for DISC. The Military Security Act of 1954 requires that military-type goods be registered with the Secretary of State before they can be exported from the United States, imported into the United States, or sold within the United States. Pursuant to this legislation a list is published (22 CFR 121) by the State Department which specifies in detail what articles are subject to the registration requirements of the Act.

Generally, a U.S. manufactured military good is competitive with a foreign manufactured product if any equipment which is the same or similar to the military good is available even though the specifications are not identical and even though the foreign purchaser generally purchases military equipment from the United States.

Exclusion from base period.—For purposes of establishing base period export gross receipts of a DISC some of the products of which have been made ineligible for DISC benefits under the amendment (or under the Tax Reduction Act of 1975), an adjustment is to be made

[46] For example, a DISC with adjusted taxable income of $130,000 which had adjusted base period export receipts of $200,000 might without the small DISC provision, have a deemed distribution of $75,000 and thus would be eligible for DISC benefits only on the remaining $55,000. However, under the 2-for-1 phaseout this DISC would be eligible for DISC benefits on an additional $40,000 of its DISC income beyond the $55,000 amount (2 times ($150,000—$130,000)). The DISC would thus be treated as having made a deemed distribution of taxable income attributable to base period export gross receipts of $35,000 out of its adjusted taxable income in the current year of $130,000.

to reduce base period export gross receipts of that DISC to reflect the elimination of DISC benefits for those products or commodities. This adjustment is to be made by eliminating from each base period year the amount of actual exports of those commodities or products for which DISC benefits are eliminated for the current year. Thus, the amount of reduction in base period export gross receipts is to be computed by tracing and eliminating actual DISC sales in base period years.

Special rules.—The committee amendment also includes two provisions relating to the disqualification and recapture of accumulated DISC income of DISCs which exported goods for which DISC benefits have been eliminated. First, under the bill, if these DISCs continue to loan their accumulated DISC earnings to the parent company, these loans will continue to qualify as producers loans if they would otherwise qualify under the rules that were applicable before DISC benefits were eliminated for the goods which the DISC exported and which the parent continues to export. For example, in the case of a DISC selling military goods, after the elimination of DISC benefits for those goods the DISC can continue to have qualified producers' loans to its parent to the extent that the parent exports goods which would (but for the elimination of DISC benefits for military goods under this bill) qualify for DISC benefits if sold through the DISC.

In addition, the committee's amendment provides that recapture of accumulated DISC earnings (because the DISC has become disqualified) is to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years), instead of the 1 year (up to a maximum of 10 years) provided under present law.

The committee amendment also includes two provisions to resolve technical problems in existing law. The first relates to recapture of accumulated DISC income upon disposition of stock of a DISC. Under present law if stock in a DISC is distributed, sold, or exchanged in certain tax-free transactions (sec. 311, 336, or 337) there is no recapture because neither of the conditions for recapture are satisfied: No gain is recognized and the corporate existence of the DISC is not terminated. The committee's amendment specifically requires recapture under these circumstances. Conforming amendments with respect to the partnership provision have also been made (sec. 751(c)).

The second provision relates to the determination of the source of distributions to meet qualification requirements. Under present law the combination of the general deemed distribution rule (which requires that shareholders be considered to have received 50 percent of the DISC's taxable income) and the rule prescribing the source of any distribution made to meet the 95 percent export receipts requirement, can result in partial double counting of the DISCs taxable income insofar as terminating deferral of taxation to its shareholders is concerned.[47]

The committee amendment meets this problem of double counting by altering the source rules for distributions to meet qualification requirements.

Under the committee amendments one-half of a distribution to meet qualification requirements (which is made to satisfy the requirement of sec. 992(a)(1)(A) relating to the 95 percent qualified export receipts requirement) is considered distributed according to the source rules of section 996(a)(2) (i.e., first out of untaxed earnings) and the remaining one-half is considered subject to the source rules of section 996(a)(1) (first out of previously taxed earnings).[48]

Finally, the committee's amendment clarifies the category of products for which DISC benefits were eliminated under the Tax Reduction Act of 1975. In that Act it was intended that DISC benefits be repealed for articles the supply of which is exhaustible or nonrenewable (such as products derived from oil or gas or hard minerals). The statute as drafted refers to products "of a character with respect to which a deduction for depletion is allowable ... under section 611". This reference to section 611 had the unintended result of including some articles the supply of which is inexhaustible or can be renewed (for example, timber). Because of this possible interpretation. the committee agreed to modify the provision by limiting its application to products for which depletion is allowable under sections 613 or 613A.

Under this provision, if a product is eligible for percentage depletion (e.g., oil or gas), the exports of that product are not entitled to DISC benefits regardless of whether that DISC or its shareholder is eligible for percentage depletion.

Effective date

In general, the DISC provisions, including the provision establishing an incremental base for DISCs, apply to taxable years beginning after December 31, 1976. However, there are exceptions. The committee's amendment provides an exception to this effective date for sales, exchanges and other dispositions made after October 2, 1975, but before

[47] For example. assume a DISC has $100 of taxable income $80 of which is attributable to qualified export receipts and $20 of which is not attributable to qualified export receipts. If the corporation qualifies as a DISC by reason of making a distribution to meet qualification requirements. $50 of the DISC's taxable income is taxed to the shareholders. The rules relating to distributions to meet qualification requirements make it necessary for the corporation to distribute $20 (the nonqualified export receipts). Since under present law distributions to meet qualification requirements are deemed to come first from accumulated DISC income (and next from other earnings and profits). the $20 is taxed in full also. This results in the taxable income attributable to the nonqualified receipts being distributed. in effect. one and one-half times—one-half as part of the 50 percent deemed distribution and in full as a distribution to meet qualification requirements.

[48] The effect of this provision can be seen by referring to the example used previously in describing the problem with present law. If a corporation has $100 taxable income. $80 of which is attributable to qualified export receipts and $20 of which is attributable to receipts which do not qualify as qualified export receipts, it can still obtain qualification as a DISC if it makes a distribution to meet qualification requirements (pursuant to sec. 992(c)) of $20. Under present law. the full $20 is (according to the present source rules) considered to be first from accumulated DISC and hence taxable in full to the distributee shareholders. Under your committee's bill. one-half of the $20 distribution is considered (according to the source rules of sec. 996(a)(1)) to be first from previously taxed income with the remaining one-half first from accumulated DISC income (pursuant to sec. 996(a)(2)). In this manner. the full amount of taxation to the shareholders (as a result of the deemed distribution of $50 pursuant to sec. 995(b)(1)(E) and the $20 distribution to meet qualification requirements) is $60 ($20 of nonqualified income plus $40, one-half of the qualified income) rather than $70 as under present law.

October 3, 1978, which are made pursuant to a fixed contract. The committee's amendment also applies this fixed contract exception to those products for which DISC benefits were eliminated under the Tax Reduction Act of 1975 (generally hard minerals and oil and gas), and allows this exception for sales, exchange and other dispositions made after March 17, 1975, but before March 18, 1980. A fixed contract is defined as any contract which was, on October 2, 1975 (or March 17, 1975) and is at all times thereafter, binding on the DISC, or on a taxpayer which is a member of the same controlled group (within the meaning of sec. 993(a)(3)) as the DISC.

The contract need not be formalized in writing in order to be binding, if the taxpayer can establish through substantial documentary evidence (such as Board of Directors' resolutions, letters of intent, etc.) that the contract was in fact binding and contained fixed price and fixed quantity provisions on and after October 2, 1975. However, the contract must not have been binding at any time prior to the date on which the DISC became qualified as a DISC or prior to the time the taxpayer and the DISC became members of the same controlled group.

In addition, only contracts under which the price and quantity terms relating to the products or commodities to be sold, exchanged, or otherwise disposed of cannot be increased with any discretion are to be considered fixed contracts. For example, if a contract permits a price increase only upon the occurrence of specified conditions not within the discretion of the seller (such as increased labor or raw material costs), which conditions do not include increases for income taxes, the contract is to be considered a fixed price contract. However, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), the contract is not to be considered a fixed price contract. Furthermore, if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of X amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

In cases where the binding contract rule allows for a continuation of DISC benefits for any DISC, the decrease in base period export gross receipts which is provided under the bill attributable to products for which DISC is eliminated is to be modified by adding back into the base period an amount of export sales equal to the amount of export sales in the base period for which DISC benefits have since been eliminated (without regard to the binding contract rule) multiplied by a fraction, the numerator of which is the amount of export sales for which DISC benefits are allowed (because of the binding contract rules) and the denominator of which is the amount of export sales for which DISC benefits would be eliminated in the curent year (assuming that the binding contract rule were not in effect.) This rule, in effect, requires that a portion of the base period export gross receipts reduction due to the general elimination of DISC benefits for certain types of products is to be included in base period export gross receipts to the extent that the binding contract rule allows a continuation of any DISC benefits for any products in the current year.

Revenue effect

This provision will increase budget receipts by $84 million in fiscal year 1977, $306 million in fiscal year 1978, and $495 million in fiscal year 1981.

L. ADMINISTRATIVE PROVISIONS

1. Disclosure of Internal Revenue Service Determinations (sec. 1201 of the Bill and new sec. 6110 of the Code)

Present law

As a well-established part of the tax system, the National Office of the Internal Revenue Service provides written advice to taxpayers on the tax treatment of their specific transactions.[1]

Advice with respect to a proposed transaction may be issued upon a written request from the taxpayer, giving factual details about the transaction and after the taxpayer answers the questions the IRS may have about the transaction. (Information provided by the taxpayer to the IRS often contains confidential financial (or personal) information about the taxpayer. Some of this information is repeated in the letter of advice that is issued by the IRS). The letter of advice generally is called a "ruling" and is in the form of a letter to the taxpayer.[2]

The letter ruling to the taxpayer has been treated as "private" in the sense that it is issued in response to the request of the taxpayer and is officially kept confidential. Even if another taxpayer obtains a copy of a private ruling, he cannot use it as a precedent in his own case. Private rulings apply only to the taxpayer who is the subject of the ruling.

In addition, the IRS publishes revenue rulings in its official bulletins. Taxpayers and IRS employees may rely on these published rulings as precedent. However, before publication, all identifying information is deleted from the proposed revenue ruling, facts may be altered to conceal identity, the position of the Service may be changed, and this sanitized version is subject to extensive administrative review.

In 1974, the Technical Office of the National Office handled 28,346 ruling requests. Approximately one-half of these (14,329) dealt with requests for changes in accounting periods and methods; these requests are handled rapidly and normally do not involve any substantive issue of general interest.[3]

[1] Statement of Procedural Rules § 601.201: Rev. Proc. 72–3, 1972–1 Cum. Bul. 698, modified by Rev. Proc. 73–7, 1973–1 Cum. Bul. 776. However, the IRS will not rule on all transactions. For example, the IRS will not rule on whether compensation is reasonable in amount or on whether a taxpayer who advances funds to a charitable organization and receives a promissory note therefore may deduct as contributions amounts of the note forgiven by the taxpayer in later years. Rev. Proc. 72–9, 1972–1 Cum. Bul. 718. In addition, in some cases, the IRS has established guidelines describing the form a transaction must take before a favorable ruling will be issued. See, e.g. Rev. Proc. 75–21, 1975–1, Cum. Bul.. 715, which sets out conditions which a transaction must meet before a favorable ruling will be granted that a transaction is a leveraged lease and not a conditional sale.

[2] While an erroneous ruling issued to a taxpayer may be modified or revoked, generally (in the absence of an omission or misstatement of material facts or change in law) an advance letter ruling which is relied upon by the taxpayer in good faith will not be modified or revoked retroactively if the facts which subsequently develop are not materially different from the facts on which the ruling was based. Statement of Procedural Rules § 601.201(1)(5).

[3] Under the Code, generally a taxpayer who changes his period or method of accounting must, before computing his taxable income under the new method, secure the consent of the IRS. (Secs. 442 and 446(e).)

Of the remaining rulings in 1974, the Technical Office responded to 14,017 taxpayer ruling requests. These ruling requests were on the following general subjects:

Subject	*Taxpayers' requests*
Actuarial matters	1,019
Administrative provisions	42
Employment and self-employment taxes	423
Engineering questions	69
Estate and gift taxes	317
Exempt organizations	4,120
Other excise taxes	421
Other income tax matters	6,196
Pension trusts	1,410
Total	14,017

The National Office of the IRS also will answer requests for advice from the district offices on issues that arise in the course of an audit of a taxpayer's return. This advice is in the form of a technical advice memorandum. Technical advice memoranda are addressed to a field office of the IRS but have an effect similar to that of a private letter ruling in that the technical advice involves a determination of tax questions concerning a particular taxpayer who generally has a right to, and usually does, participate in the technical advice proceeding. In 1974, the IRS handled 1,602 requests for technical advice.

In 1974, the IRS published 626 revenue rulings in its official bulletin. The source of these revenue rulings was both private rulings and technical advice memoranda. In one of the areas of tax law generally considered to be very complex—that of corporate reorganizations—the IRS published 25 rulings in 1974. In that same year, there were approximately 2,000 private rulings issued in the corporate reorganization area.

The Freedom of Information Act (FOIA) (5 U.S.C. § 552) became effective on July 4, 1967. The FOIA requires each agency to make available for public inspection and copying "interpretations which have been adopted by the agency * * *." (5 U.S.C. § 552(a) (2)(B).) However, there are a number of exceptions from the requirement of disclosure under the FOIA, including matters that are specifically exempted from disclosure by statute. (5 U.S.C. § 552(b) (3).)

Recently, the courts have considered the issue of whether private rulings are exempt from disclosure under the FOIA because they constitute tax returns (or return information) under the Internal Revenue Code (secs. 6103 and 7213). In these cases, both the United States Court of Appeals for the District of Columbia and the United States Court of Appeals for the Sixth Circuit held that private letter rulings were not covered under secs. 6103 and 7213 of the Code and were subject to disclosure under the FOIA. *Tax Analysts & Advocates v. Internal Revenue Service*,[4] *and Fruehauf Corp. v. Internal Revenue Service.*[5]

In addition, in *Fruehauf*, the court held that technical advice memoranda were to be open to inspection to the extent intended for issu-

[4] 505 F. 2d 350 (D.C. Cir. 1974).
[5] 522 F. 2d 284 (6th Cir. 1975), petition for cert. granted Jan. 12, 1976.

ance to a taxpayer. However, in *Tax Analysts*, the court held that a technical advice memorandum was not open to inspection, being a part of a tax return and therefore exempt from disclosure under the FOIA (by reason of secs. 6103 and 7213 of the Code).

In 1975, a suit was brought under the FOIA to compel release of all private letter rulings issued by the IRS since July 4, 1967, the effective date of the FOIA. *Tax Analysts & Advocates v. Internal Revenue Service*, Civil Action No. 75–0650 (D.D.C.), filed April 28, 1975.

On December 10, 1974, the IRS issued proposed procedural rules dealing with the publication of private rulings. In general, these proposed rules provide for public inspection beginning approximately 30 days after the issuance of the ruling. (Furthermore, in certain cases, a delay in public inspection could be granted for an additional period not to exceed 13 weeks.) Under these proposed rules, the IRS would make available for public inspection the full text of private rulings, including identifying information. However, these proposed rules provide procedures for protecting trade secrets and certain matters relating to national defense or foreign policy.

On March 25, 1975, the IRS held public hearings on these proposed rules, at which time there was substantial public comment. In addition, the IRS was informed by the Justice Department that at least one part of the proposed rules (dealing with "required rulings") might be contrary to other principles of law.

Reasons for change

Although the private rulings procedure has significant advantages for both the IRS and taxpayers, the system also contains some substantial problems. It has been argued that the private ruling system has developed into a body of law known only to a few members of the tax profession. For example, an accounting or law firm with offices in Washington may have a library of all the private ruling letters issued to its clients. Such a firm may be in a position to advise other clients as to the current IRS ruling position because of its special access to these rules of law. This, in turn, has tended to reduce public confidence in the tax laws. Additionally, the secrecy surrounding letter rulings has generated suspicion that the tax laws are not being applied on an even-handed basis.

These types of concerns led to the lawsuits described above to open private rulings to public inspection. While two courts have held private rulings to be open to public inspection, significant additional questions have been raised since these court decisions. These questions concern the parts of a ruling file that should be published, whether private rulings should be available as "precedent" for other taxpayers, what procedures should be established to allow taxpayers to claim that protected material should not be disclosed, etc.

The foregoing questions generally apply to future as well as to past rulings. There are additional questions concerning past rulings, however, because taxpayers who previously obtained rulings applied for them in reliance on the IRS position that the information submitted to the IRS would be treated as confidential tax information.

The committee agrees with the previous court decisions that private rulings should be made public. Only in this way can all taxpayers be assured of access to the ruling positions of the IRS. Also, this will tend to increase the public's confidence that the tax system operates fairly and in an even-handed manner with respect to all taxpayers. However, the committee believes that the problems described above should be resolved by legislation, since the courts have not previously been given guidance by the Congress on these difficult issues in the tax field.

The problems should be resolved so that the public will have an exclusive remedy with respect to the disclosure of rulings and related material.

Explanation of provision

Under the committee amendment, IRS written determinations, *i.e.*, rulings, technical advice memoranda, and determination letters would generally be open to public inspection; that is, they would be made available for public inspection and copying in a public reading room in or near the issuing office. A complete set of IRS rulings and technical advice memoranda would be made available in a central public reading room in Washington, D.C. It is intended that a subject-matter index would also be placed in the public reading rooms. This index would classify rulings, etc., on the basis of the Code sections and issues involved. (It is anticipated that, as is presently the case with respect to other aspects of the tax law, various commercial services will make pertinent parts of this material available to people located elsewhere.) However, it is not contemplated that existing IRS indices will be disclosed. The House bill achieved a similar result.

Generally, any written determination issued by the IRS (including written determinations issued at the District Director's level as well as National Office rulings) is to be open to public inspection under the committee amendment. Generally, a written determination would not be considered a ruling, technical advice memorandum, or determination letter unless it recites the relevant facts, explains the applicable provisions of law, and shows the application of the law to the facts. Thus, documents such as a notice of deficiency (sec. 6211), reports on claims or refund, or similiar documents required to be issued by the IRS in the course of tax administration would not be considered rulings. Public inspection would apply only to a written determination actually issued to a person pursuant to his request and to a written determination (such as a technical advice memorandum) requested by an IRS employee in the course of an audit, tax collection, or similar proceeding. Public inspection would not apply to unissued written determinations or background information with respect to them.

Moreover, the committee amendment does not provide for the public inspection of technical advice memoranda issued in connection with fraud and jeopardy proceedings until after such proceedings are completed.

Additionally, the committee amendment would not require public disclosure of a closing agreement entered into between the IRS and a taxpayer which finally determines the taxpayer's tax liability with respect to a taxable year. (Where it is in the interest of a taxpayer and the IRS, a closing agreement may be made in order to provide certainty as to a person's past tax liability.) The committee understands that a closing agreement is generally the result of a negotiated settlement and, as such, does not necessarily represent the IRS view of the law. The committee intends, however, that the closing agreement exception is not to be used as a means of avoiding public disclosure of determinations which, under present practice, would be issued in a form which would be open to public inspection under the committee amendment.

Similarly, the committee amendment does not apply to an IRS decision to accept a taxpayer's offer in compromise under a special procedure designed to permit the compromise of disputed issues. Summaries of accepted offers in compromise are open to public inspection under present law. (The committee amendment does not in any way change these provisions of present law.)

The committee amendment also does not apply to IRS determinations issued after September 2, 1974 as to whether a pension, profit-sharing, etc., plan, an individual retirement account, or an individual retirement annuity qualifies under the tax law, or as to whether an organization is tax-exempt, because these determinations are generally open to public inspection under present law (sec. 6104(a)(1)). Also, the committee amendment specifically requires the disclosure (sec. 6104) of determination letters with respect to applications filed after October 31, 1976, issued to an organization described in section 501 (c) or (d) with respect to its tax-exempt status.

Generally, under the committee amendment, the text of a determination, after having been sanitized so that there are no identifying details, is to be made open to public inspection. This differs from the approach taken in the House bill, under which the full text of a determination (including the name and address of the person to whom it is issued) issued after July 4, 1967 would be made open to public inspection.

Under the committee amendment, identifying details consist of names, addresses, and any other information which the Secretary determines could identify any person, including the taxpayer's representative. In some situations, information included in a determination (other than a name or address) may not identify a person as of the time the determination is made open to public inspection, but that information, together with information that is expected to be disclosed by another source at a later date, will serve to identify a person. Consequently, in deciding whether a determination contains identifying information, the Secretary is to take into account information that is available to the public at the time that the determination is made open to public inspection as well as information that is expected to be publicly available from other sources within a reasonable time after the determination is made open to public inspection.

Generally, it is intended that the standard the IRS is to use in determining whether information will identify a person is a standard of a reasonable person generally knowledgeable with respect to the appropriate community.[6] The standard is not, however, to be one of a person with inside knowledge of the particular taxpayer.

[6] The appropriate community could be, e.g., an industry or a geographical community and will vary for the problem involved. For example, the "community" for a steel company will be all steel producers, but may be also the locale in which, e.g., the main plant is to be located if the determination deals with a land transaction.

Before any written determination requested after October 31, 1976, is made available for public inspection, any person who receives a ruling or determination letter or to whom a technical advice memorandum pertains must be personally notified in writing that public disclosure is about to occur. It is intended that this notification be made at the time the written determination is issued. Such person will then have 60 days within which to discuss with the IRS the information to be made available for public inspection and to bring a suit to restrain disclosure. It is expected that the IRS will develop administrative procedures which will facilitate the settlement of disputes without litigation. It is also expected that the IRS will not make any written determination open to public inspection before it advises the person to whom it pertains, in writing, as to any deletion which he has requested but with which the IRS disagrees. Moreover, the IRS may not make any written determination available for public inspection until 15 days after the initial 60-day period has expired, but it must make the written determination available no later than 30 days after such initial 60-day period has expired if no court proceedings are commenced. Such 60-day period will start on the date the IRS actually mails a notice to the person to whom the determination pertains, indicating that the written determination that he received is about to be made public. If any court action is commenced during such 60-day period to challenge the decision of the IRS with respect to disclosure, the IRS may not make the disputed portion of the written determination open to public inspection until after a final court decision.

In order to protect against impropriety and undue influence in the rulings, etc., process, the committee amendment establishes a flagging procedure with respect to written determinations requested after October 31, 1976. If a particular determination is the subject of a contact (written or otherwise) by anyone other than the taxpayer or his representative before the determination is issued, the IRS will be required to note that fact at the time the determination is made public, by noting the date of the contact and by identifying the nature of the contact by category, e.g. White House, Congressional, Department of the Treasury, trade association, etc. It is expected that the IRS will make a written notation of all telephone contacts from outside parties with respect to a particular written determination. Contacts made by an employee of the IRS are not to be noted. For this purpose, employees of the Office of Chief Counsel of the IRS are to be considered employees of the IRS. In addition, contacts made by the Chief of Staff of the Joint Committee on Internal Revenue Taxation are not to be noted.

If any person wishes to obtain further information regarding the identity of the contacting party and the nature of the contact, he may request access to the IRS background files. Upon payment of the charges for search, deletion and copying (subject to provisions for a reduction or waiver of these charges where the disclosure is in the public interest), the IRS will be required to make available to the third party information in the background file pertaining to the contact made, including the name of the contacting party and the person to whom the contact was addressed. Moreover, if a third party wishes to learn the identity of the applicant for the written determination, he may bring suit in the tax court or the United States District Court for the District of Columbia. The identity of the applicant may not be disclosed unless the court finds evidence in the record from which one could reasonably conclude that an impropriety occurred or that undue influence was exercised, and if the court finds that the disclosure would be in the public interest.

The committee amendment, in addition for providing for the deletion of identifying details from determinations made available for public inspection, adopts in general the exemptions from public disclosure under the FOIA. The House bill included certain of these exceptions, but the committee amendment conforms more closely to the FOIA standards.

As part of the procedure for obtaining an IRS determination, a taxpayer is required to submit detailed relevant factual information for IRS consideration. Frequently, this information is repeated in the IRS determination. The committee is concerned that if a taxpayer's confidential information necessary for an IRS determination is open to public inspection, the taxpayer may be injured financially or by loss of his personal privacy. As a consequence, taxpayers may become reluctant to request an IRS determination (even though their names will be deleted from the material made public).

The committee does not intend that the IRS ruling program should be hindered by public disclosure. The ruling program benefits both taxpayers and the IRS (which obtains advance information about transactions through the ruling program). The committee amendment, therefore, provides that trade secrets and commercial or financial information obtained from a person and privileged or confidential is not to be publicly disclosed. However, in determining the information to be deleted, the IRS, except where the item to be disclosed relates to a trade secret, is directed to take into account the fact that generally, the identity of the taxpayer will not be made public.

Where the structure of a transaction is disclosable but disclosure of the amounts involved is not allowed under this rule, the committee believes that in normal circumstances the application of the tax law can be fully demonstrated by using "artificial" numbers, for example, by substituting $8X and $9X for $400 and for $450.

The committee amendment also provides for the deletion of information the disclosure of which would constitute an unwarranted invasion of personal privacv. Under this provision, matters including (but not limited to) a pending (but not yet public) divorce; medical treatment for, *e.g.*, cancer; adoption of a child; or the amount of an individual's gift usually would be protected.

The committee amendment, following the FOIA exceptions, goes on to provide for the deletion of matters that are specifically required by Executive order to be kept secret in the interest of the national defense or foreign policy, and which are in fact properly classified pursuant to the Executive order; geological and geophysical information and data, including maps, concerning wells: and matters contained in or related to examination, operating or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions. This last exception is needed *e.g.*, to protect the standing of financial institutions. For example, a regulatory agency may issue a confidential report requiring such an institution to classify a loan as a bad debt. Subsequently, the IRS may be called upon to determine whether the loan should be treated as a bad debt for tax purposes. The IRS may, of course, take the agency's report into account in deciding upon the proper tax treatment of the item. The committee believes, however, that the banking agency's report should not be publicly disclosed by the IRS determination because it may damage the standing of the bank. Consequently, the committee amendment, like the House bill, provides for deletion of this type of information contained in the reports of such agencies.

Additionally, the committee amendment, like the House bill, requires deletion of information which is exempt from disclosure under another Federal statute which applies to the IRS. In some cases, a statutory nondisclosure provision applies only to a particular agency; in other cases, such a provision may apply to all agencies. Under the committee amendment, information submitted to another Federal agency by a person under a nondisclosure rule applicable only to that agency would not be exempt from disclosure by the IRS merely because that person also submitted the information to the IRS. Of course, if the IRS obtained the information directly from the other agency under a nondisclosure rule of that agency, it would not be subject to disclosure by the IRS.

However, if in an action for disclosure of the identity of an applicant for an written determination, the court determines that disclosure of identity is appropriate, it may also, under appropriate circumstances, direct the IRS to make public any portion of the material deleted under the FOIA exemptions adopted by the committee.

Under the committee amendment, unlike the House bill, disclosure is not limited to the written determination alone. Although initially, only the determination will be made available, the background file may be obtained by the public upon request, after payment of charges for search, deletion of identifying details, and copying. However, these charges may be reduced or waived where disclosure is in the public interest, and it is anticipated that no further charge will be made for deletions in the case of a subsequent request for the same background file document. Background files need not be made available for public inspection and copying in a public reading room.

Aside from the request for a determination, the background file includes, but is not limited to, correspondence between the IRS and the taxpayer and third party submissions. However, background files would not be available for public inspection with respect to general written determinations issued prior to July 4, 1967.

Also the committee amendment recognizes that under some circumstances, it serves no purpose to disclose written determinations dealing with changes of accounting methods or taxable years, which are almost always routine. Therefore, under the committee amendment, IRS determinations regarding approval of the change of a taxpayer's taxable year or accounting method, of the accounting year or funding method of a qualified pension, etc., plan, or of a partner's or partnership's taxable year must be disclosed only if the IRS regards it as a guideline. Routine determinations in this area, together with background information, will be subject to disclosure only if the determination is requested after October 31, 1976, and, then, only if the third party seeking such a determination pays the charges for search, deletions, and copying.

Information which is contained in a written determination or background file document, but which is not made open to public inspection under the new rules, is treated as "return information" and subject to the nondisclosure rules of section 6103.

Under present administrative rules, a private letter ruling, technical advice memorandum, or determination letter is not to be used as a precedent by the IRS or any person. If all publicly disclosed written determinations were to have precedential value, the IRS would be required to subject them to considerably greater review than is provided under present procedures. The committee believes that resulting delays in the issuance of determinations would mean that many taxpayers could not obtain timely guidance from the IRS and the rulings program would suffer accordingly. Consequently, both the committee amendment and the House bill codify the present administrative rules by providing that determinations which are required to be made open to public inspection are not to be used as precedent. Thus, if the IRS issued a written determination to a taxpayer with respect to a specified transaction which occurred in a particular year, and that taxpayer or any other taxpayer engages in the same transaction in a subsesequent year, the earlier determination could not be used by the taxpayer or the IRS as a precedent for the subsequent year unless the determination specifies that it applies to a series of such transactions.

However, under the committee amendment, the IRS may, but only in a widely circulated official government publication (such as the Internal Revenue Bulletin), designate determinations which will be used as precedent, except that the precedential value, if any, of excise tax determinations will remain the same as under current law.

The committee amendment relates to the disclosure of all rulings, technical advice memoranda, and determination letters, whether or not issued after July 4, 1967. However, certain rules to determine the order in which disclosure is to occur are provided in the case of those rulings, etc., reauested prior to November 1, 1976. In general, no such rulings, etc., will be available prior to the prescribed time. Contingent upon the availability of funds specifically appropriated to the IRS for the purpose of making prior determinations open to public inspection, the IRS is directed to release, on a last-in, first-out basis. all prior determinations issued under the 1954 Code which have been used by the IRS as guidelines for other determinations. Thereafter. the IRS is directed to release, on the same basis, all prior non-guideline determinations (other than non-guideline determination letters) issued after July 4, 1967. Third, the IRS is directed to release, on a last-in, first-out basis, all prior determinations issued under the internal revenue laws as in effect prior to the 1954 Code which have been used by the IRS as guidelines for other determinations. Finally, determinations issued on or before July 4, 1967 will not be formally released by the IRS, although they will be available upon request after they are made open for public inspection. but only upon payment of charges for search, deletion, and copying. In no event, however, is the disclosure of IRS written determinations under pending court actions to be delayed under the above rides.

Unlike the House bill, the committee amendment includes a records disposal provision, to enable the IRS to follow its normal records disposition procedures. The IRS may not dispose of any written determination which it has used as a guideline for other determinations. The IRS may dispose of any other written determination requested after October 31, 1976 not earlier than 3 years after the document is first made available to the public for general written determinations requested prior to November 1, 1976, however, the committee amendment extends the retention date to January 20, 1979. Moreover, if funds are appropriated so that the IRS will be able to make prior determinations open to public inspection, the IRS will be unable to dispose of such prior determinations earlier than 3 years after the document is first made available to the public. This record retention provision in the committee amendment relates not only to a written determination but also to the related background file.

It is anticipated that the IRS is to establish a special temporary unit for the purpose of making prior determinations open to public inspection and that this unit is to be phased out as these prior determinations are made public.

Under both the committee amendment and the House bill, the IRS is to issue notice in the *Federal Register* of the application of the new disclosure rules to prior determinations requested before November 1, 1976, and the intent to make them public. It is understood that a notice may relate only to a limited category of determinations (for example, determinations issued between July 4, 1967, and December 1, 1967. No part of such a prior determination is to be made open to public inspection under these rules before the expiration of 90 days following the notice in the *Federal Register*. If any court action is commenced during the first 75 days within such 90-day period to challenge the decision of the IRS with respect to disclosure, the IRS may not make the disputed portion of the written determination open to public inspection until after a final court decision.

Generally, a written determination which is required to be made open to public inspection under the committee amendment is to be placed in a public reading room in or near the office where issued (such as the National Office or the District Office, where appropriate) no earlier than 75 days and no later than 90 days after the IRS actually notifies the person who receives any ruling or determination letter or to whom a technical advice memorandum pertains of the impeding disclosure. However, prior determinations may not be made open to public inspection until 90-days after publication of the required notice in the *Federal Register*. Moreover, in the event of litigation, disclosure is to be made within 30 days after the final determination, unless an extension is granted by the court.

In order to prevent interference with pending transactions, however, the committee amendment and the House bill provide for public inspection to be delayed where necessary until the completion of a transaction involved in the determination. Under this provision, disclosure may be delayed (for an initial period of up to 90 days) until 15 days after the Secretary determines that the transaction is completed. The first extension is to be automatic on a showing that the transaction will not be completed until the period in question has passed. A second extension (up to an additional 180 days) could be granted where the transaction is not complete at the end of the initial period and the Secretary determines that there is good cause for delay. The burden of showing good cause is to be on the person requesting the delay. The second extension would expire not later than 15 days after the date of the Secretary's determination that the transaction is complete. Thus, if both extensions are allowed for the completion of a transaction, the determination is to be made open to public inspection within 360 days after it is issued.

If a written determination and related background file is made open for public inspection and the IRS intentionally or willfully fails to delete any information required to be deleted or to follow the prescribed disclosure procedures, the recipient of the written determination or any person identified in the written determination may bring a civil action in the Control of Claims for damages.

If agreement cannot be reached between the Secretary and the person who receives a ruling or determination letter or to whom a technical advice memorandum pertains as to the extent of public disclosure, and administrative remedies have been exhausted, the person involved may petition the Tax Court for a decision as to whether the disputed portion of the IRS determination or background file document is properly open to public inspection under the new rules. If such a petition is not filed, the Secretary is to make the determination or document open to public inspection under the new rules in accordance with his findings, within the time period described above.

A petition must be filed with the Tax Court before the IRS determination or background file document has been made open to public inspection under the new rules. A petition is to be served on the Secretary, and within 15 days after the petition is served on him, the Secretary is to notify (by registered or certified mail) any person to whom the determination pertains (other than the petitioner) of the filing of the petition. Once a person has received a notice of the filing of the petition, he may intervene in the case but he may not thereafter file a petition himsef. (This will ensure that all issues of confidentiality raised before public inspection is allowed and arising out of a single IRS determination are heard in one action before the Tax Court.) The Tax Court proceedings could be *in camera* to the extent necessary to preserve protected information from being disclosed as a result of the proceedings. The Tax Court would be required to make a decision in the case at the earliest practicable date and expedited in every way. It is expected that the rules of the Tax Court will permit disclosure cases to be heard at the same locations at which tax cases are heard and additionally will permit any disclosure case under the amendment to be heard in Washington, D.C. The burden in the case would be on the person seeking to restrain disclosure.

A decision of the Tax Court in such a case could be appealed only to the United States Court of Appeals for the District of Columbia unless the Secretary agrees with the person involved to review by another court of appeals (sec. 7482(b)). The IRS determination would be made open to public inspection solely in accordance with a final decision of the Tax Court, except to the extent that additional disclosure is required in a later action to obtain additional public disclosure (discussed below).

The committee amendment, like the House bill, provides a special procedure for third parties to obtain additional disclosure of an IRS written determination or background file document (or portion thereof) which has not been made open to public inspection. This is required so that independent third parties can challenge IRS decisions as to what part of a written determination or document is to be made public. A person seeking additional disclosure of an IRS written determination or background file document is to submit a written request for the information to the IRS. The Secretary is to provide administrative remedies for a person seeking greater disclosure. After exhausting such remedies, the person seeking additional disclosure could petition the Tax Court or file a complaint in the District Court for the District of Columbia to compel additional disclosure. It is expected that the rules of the Tax Court will prove that the actions may be brought at the same locations at which tax cases are heard and at Washington, D.C., and that rules will be developed to prevent subsequent relitigation with respect to the same written determination or document. No action to compel additional disclosure of a written determination could be brought more than 3 years after any portion of the determination is made open to public inspection under the new rules.

The court is to examine the matter *de novo* and without regard to a decision to restrain or permit disclosure in any court action between the IRS and a person involved in the written determination or related background file document. The proceedings would be subject to the same rules that would apply under the FOIA if the proceeding were brought under the FOIA on the date of enactment of the bill. Thus, for example, the IRS would generally be required to file its answer within 30 days after the petition or complaint is filed, the case would have a high priority on the docket of the court, the petitioner or complainant could be awarded costs where he substantially prevails in the action, disciplinary proceedings could be commenced against IRS employees in appropriate cases, and failure to comply with a court order compelling additional disclosure could be punished under contempt rules. As under the FOIA, the burden would be on the Secretary or other parties seeking to prevent additional disclosure.

Additionally, the committee amendment provides that where a petition or complaint is filed to compel additional disclosure the Secretary is to notify any person identified by name and address in the written determination within 15 days after the petition or complaint is served on the Secretary. Such person and any person to whom such written determination pertains could intervene in the case. After sending the notice, the Secretary would not be required to defend the case and would not be liable on account of disclosure of the determination (or any portion thereof) in accordance with a final decision of the court.

A decision of the Tax Court in such a case could be appealed only to the United States Court of Appeals for the District of Columbia unless the Secretary agrees with the person involved to review by another court of appeals (sec. 7482(b)).

Under the committee amendment, the public inspection of rulings, technical advice memoranda, and determination letters and related background files could be accomplished only pursuant to the rules and procedures set forth in the amendment, and not those of any other provision of law, such as the FOIA. However, the amendment is not to be construed as excluding production pursuant to a discovery order made in connection with a judicial proceeding, or with respect to requests pending in the courts under the FOIA.

Effective date

The new rules would apply after October 31, 1976.

Revenue effect

This provision has no effect on Federal revenues.

2. Disclosure of Tax Returns and Tax Return Information (sec. 1202 of the bill and sec. 6103 of the Code)

a. In general

Present law

Under present law, all income tax returns are described as "public records." However, tax returns generally are open to inspection only under regulations approved by the President, or under Presidential order.[1]

This applies to returns concerning income tax, estate tax, gift tax, manufacturers excise taxes, communications tax and transportation tax. The statute does not cover returns concerning a number of other types of taxes.[2]

Additionally, the statute provides a number of specific situations in which tax returns can be disclosed. State and local government officials may inspect tax returns for the purpose of administering State and local tax laws. (Sec. 6103 (b).) Shareholders owning at least 1 percent of the outstanding stock of a corporation may examine the returns of the corporation and its subsidiaries. (Sec. 6103(c).)

Whether a person has filed a tax return is information available to the public. (Sec. 6103(f).)

Returns are available to the Department of Labor and the Pension Benefit Guaranty Corporation as needed to administer the 1974 pension reform act. (Sec. 6103(g).)

Generally, unlawful disclosure of tax information by a Federal or State employee is punishable by a $1,000 fine or a year of imprisonment, or both. A Federal employee also is to be dismissed from office or discharged from employment for unlawful disclosure. Sec. 7213(a) (1).)

[1] Under the statute, income tax returns are open to inspection upon order of the President and under Treasury rules and regulations approved by the President (sec. 6103(a) (1)) and also are "open to public examination and inspection" to the extent authorized in rules and regulations established by the President. (Sec. 6103(a) (2).)

Estate and gift tax returns and miscellaneous excise tax returns also are open to inspection under rules and regulations established by the President.

[2] Classes of returns open to inspection at the Commissioner's discretion include: (a) Rules Applicable to Recovery of Excessive Profits on Government Contracts. (Chapter 4); (b) Federal Insurance Contributions Act (Chapter 21); (c) Railroad Retirement (Chapter 22); (d) Collection of Income Tax at Source on Wages (Chapter 24); (e) Special Fuels (Subchapter E of Chapter 31); (f) Taxes on Wagering (Chapter 35); (g) Certain Other Excise Taxes (Chapter 36)—(1) Occupational Tax on Coin-Operated Devices (Subchapter B.) (2) Tax on Use of Certain Vehicles (Subchapter D), (3) Tax on Use of Civil Aircraft (Subchapter E); (h) Sugar (Subchapter A of Chapter 37); (i) Regulatory Taxes (Chapter 39); (j) Private Foundations (Chapter 42); (k) Taxes on Distilled Spirits, Wines, and Beer (Chapter 51); (1) Taxes on Tobacco, Cigars, Cigarettes and Cigarette Papers and Tubes (Chapter 52); (m) Taxes on Machine Guns and Certain Other Firearms (Chapter 53). IRM 1272, Disclosure of Official Information Handbook 320.

These statutory rules have been supplemented by a number of regulations and executive orders. The regulations are of two general types, those allowing inspection on a case-by-case basis, and those allowing general inspection of tax returns. On a case-by-case basis, every Federal agency may have access to tax returns on the written request of the head of the agency and in most cases in the discretion of the Secretary of the Treasury or the Commissioner. Under these "case-by-case" regulations, returns have been made available to a number of agencies.[3]

Also, returns are available on a case-by-case basis to an attorney of the Department of Justice (or U.S. attorney) "where necessary in the performance of his official duties." (Reg. § 301.6103(a)–1(g).) Returns are also available to the Department of Justice for use in litigation in which the United States is interested in the result. (Regs. § 301.6103–1(b).

The regulations allowing general inspection of tax returns apply to a few specific agencies and provide that the agency in question may obtain tax returns for given purposes. Under these regulations, the agency in question does not have to specify the reason for inspection, the person who will inspect, etc. The amount of information disclosed under these regulations varies with the agency. In other cases, disclosure may occur with respect to several thousand returns a year and in other cases (involving use for statistical purposes), disclosure of limited amounts of information regarding millions of taxpayers may occur each year.[4]

In addition to the provisions of the Internal Revenue Code and the Treasury regulations, the Privacy Act of 1974 (Public Law 93–579) and the Freedom of Information Act (5 U.S.C. 552) affect the disclosure of tax information. The Privacy Act generally prohibits an agency from disclosing any of its records concerning an individual to another agency without that individual's consent. However, under this Act, records may be disclosed to other agencies without such prior consent for a "routine use," for civil and criminal law enforcement activities, to the Bureau of the Census for census purposes, and in certain other cases.

Reasons for change

It has been stated that the IRS probably has more information about more people than any other agency in this country. Consequently, almost every other agency that has a need for information

[3] Disclosure of tax returns has been made under this provision. e.g., to the Civil Service Commission, the Department of Defense, the Federal Communications Commission, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Federal Power Commission, the Federal Trade Commission, the Department of the Interior, the Interstate Commerce Commission, the National Labor Relations Board, the Post Office, the Small Business Administration, the Tennessee Valley Authority. the Department of Transportation, and the Veterans Administration. In many of these situations, only a few returns were involved. Generally, the returns were used for investigative purposes in connection with matters within the jurisdiction of the agency.

[4] Under the general inspection regulations, tax information may be obtained by the Department of Health, Education, and Welfare to administer title II (old age, etc. benefits) of the Social Security Act (Regs. § 301.6103(a)–100); by the Securities and Exchange Commission for statistical purposes (Regs. § 301.6103(a)–102); by the Advisory Commission on Intergovernmental Relations for studying the coordination and simplification of the tax laws (Regs. § 301.6103(a)–103); by the Department of Commerce and the Renegotiation Board "in the interest of the internal management of the government" (Regs. § 301.6103(a)–104. 105): and by the Federal Trade Commission to aid in carrying out the Federal Trade Commission Act (Regs. § 301.6103(a)–106). Also, the regulations provide that standing committees of Congress may obtain tax information as authorized by executive order and resolution of the committee (Regs. § 301.6103(a)–101).

about U.S. citizens, therefore, logically seeks it from the IRS. However, in many cases the Congress has not specifically considered whether the agencies which have access to tax information should have that access.

The statutory rules governing the disclosure of tax information have not been reviewed by the Congress for 40 years. Since that time a number of rules allowing disclosure of tax information to other government agencies have been established by executive order and regulation.[5]

Additionally, questions recently have been raised with respect to disclosure of tax information to the White House. Apparently, tax information was transmited to the White House on a number of well known individuals. Also, tax returns have been provided White House employees in previous administrations.

Among the Federal agencies, one of the biggest users of tax information on an individual case basis (as against a "mass" basis for statistical use) is the Department of Justice. Often this information is used in the investigation of nontax cases, including all types of criminal cases, civil cases involving tort liability of the Government, anti-trust cases, etc. Also, this information is used by strike forces, with IRS agents and agents of other agencies combining their efforts in criminal investigations.

Information on tax returns is provided to other agencies for statistical use. In many cases, this information contains limited items and is used largely as the basis for developing a sample of persons to be polled by the agency. (This information also is used to provide a distribution of revenue sharing funds under the statutory formula.) On the other hand, recently an executive order allowing the Department of Agriculture access to tax information to assist in developing farm statistics was withdrawn after much public and congressional criticism.

Substantial tax information also is provided to State and local governments. In this respect, it has been suggested that there may be inadequate safeguards for preventing unauthorized disclosure of tax information by some State and local governments.

Questions have been raised and substantial controversy created as to whether the present extent of actual and potential disclosure of return and return information to other Federal and State agencies for nontax purposes breaches a reasonable expectation of privacy on the part of the American citizen with respect to such information. This, in turn, has raised the question of whether the public's reaction to this possible abuse of privacy would seriously impair the effectiveness of our country's very successful voluntary assessment system which is the mainstay of the Federal tax system.

In a more general sense, questions have been raised with respect to whether tax returns and tax information should be used for any purposes other than tax administration.

[5] However, a number of regulations allowing disclosure were established before 1934, which was the last time the Congress dealt specifically with disclosure. These regulations include allowing other government agencies to inspect corporate and individual returns on a case-by-case basis, allowing the Department of Commerce to inspect returns for statistical purposes, allowing inspection by persons with a material interest in the return, and permitting a special Senate committee to examine returns.

Recent Congressional action with respect to privacy in general has had an impact on the disclosure of tax information. (Privacy Act of 1974, Public Law 93-579.) However, the Congress did not specifically focus on the unique aspects of tax returns in the Privacy Act.

The committee has reviewed each of the areas in which returns and return information are now subject to disclosure.[6]

With respect to each of these areas, the committee has tried to balance the particular office or agency's need for the information involved with the citizen's right to privacy and the related impact of the disclosure upon the continuation of compliance with our country's voluntary assessment system.

Although present law describes income tax returns as "public records", open to inspection under regulations approved by the President, or under Presidential order, the committee felt that returns and return information should generally be treated as confidential and not subject to disclosure except in those limited situations delineated in the newly amended section 6103 where the committee decided that disclosure was warranted.

There is no comparable provision in the House bill.

Explanation of provision

The committee amendment provides that as the general rule returns and return information are to be confidential and not subject to disclosure except as further provided in the section. Only those regulations now in effect and subsequently promulgated by the Secretary which interpret a specific provision of section 6103 are to continue to have force and effect after the effective date of this amendment. Consequently, those regulations promulgated under Presidential authority prior to the effective date of the amendment which do not interpret any specific provision of this section are no longer to have any force and effect after the effective date of this amendment.

Under the committee amendment, section 6103 applies to the disclosure of a "return" or "return information." "Return" is defined to mean any tax or information return, declaration of estimated tax or claim for refund which, under the code, is required (or permitted) to be filed on behalf of or with respect to any person. It also includes any amendment, supplemental schedule or attachment filed with the tax return, information return, etc. However, a "written determination" (as defined under section 6110(b)) which is included with or attached to a return filed by a taxpayer is not to be considered a return.

The term "return information" is to include the following data pertaining to a taxpayer: his identity, the nature, source or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments and tax payments. It also includes any particular of any data, received by, recorded by, prepared by, furnished to, or collected by the IRS with respect to a return filed by the taxpayer or with respect to the determination of the existence, or possible existence, of liability (including the amount of liability) for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense provided for under the code.

[6] Many of the situations in which disclosure is now allowed are not based upon any specific provision of the Code, but instead derive from regulations prescribed by the President under the general authority provided him to do so under section 6103(a).

Information as to whether a taxpayer's return was, is being, or will be examined or subject to other investigation or processing is also to be considered return information.

Return information is to include any part of any "written determination or any background file document relating to such written determination" (as these terms are defined in section 6110(b)) which is not open to public inspection under section 6110.

"Taxpayer return information" is return information which is filed with or furnished to the IRS by or on behalf of the taxpayer to whom the return information relates. This includes, for example, data supplied by a taxpayer's representative (e.g., his accountant) to the IRS in connection with an audit of his return. It would also include any data received by the IRS from a taxpayer's representative pursuant to an administrative summons which was issued in connection with an IRS civil or criminal tax investigation of the taxpayer.

The term "taxpayer identity" means the name of a person with respect to whom a return is filed, his mailing address, and his taxpayer identifying number (as defined in section 6109), or a combination thereof.

The term "disclosure" means the making known to any person in any manner whatever, including inspection, a return or return information. The terms "inspected" and "inspection" mean any examination of a return or return information.

b. Disclosure to Congress

Present law

Congressional committees fall into three categories for disclosure purposes. The tax committees may inspect tax information, in executive session. (Sec. 6103(d).) Select committees of the House and Senate may inspect tax information, in executive session, if specifically authorized to do so by a resolution of the appropriate body. (Sec. 6103(d).) Standing and select committees may inspect tax information under an executive order issued by the President for the committee in question,[7] and on the adoption of a resolution (by the full committee) authorizing inspection. (Regs. § 301.6103(a)–101.) The resolution must set out the names and addresses of the taxpayers in question and the periods covered by the returns to be inspected. Subcommittees may inspect tax information under an executive order and resolution of the full committee. The designated agents of any authorized committee also may inspect tax information. (Sec. 6103(d), Regs. § 301.6103 (a)–101.)

The tax committees and select committees authorized to inspect tax information may submit "any relevant or useful" information obtained to the House or Senate. (Sec. 6103(d)(1)(C).)

Reasons for change

While the Congress, particularly its tax-writing committees, requires access in certain instances to the data contained in return and return information in order to carry out its legislative responsibilities,

[7] A new executive order must be issued every two years for a committee that wants to continue to obtain tax information, because an executive order is good only for the Congress in which it is issued.

the committee decided that the Congress could continue to meet these responsibilities under more restrictive disclosure rules than those provided under present law.

Explanation of provision

Under the committee amendment the Committee on Ways and Means, the Committee on Finance, and the Joint Committee on Internal Revenue Taxation, upon written request of their respective chairmen, would continue to have access to returns and return information. Duly authorized subcommittees of these Committees would also have access to returns and return information upon written request of the Chairmen of these Committees. However, returns and return information would be required to be received in a closed executive session unless the returns and return information would not identify a taxpayer or that taxpayer consented in writing to the disclosure of his identify.

The Chief of Staff of the Joint Committee on Internal Revenue Taxation is to continue to have access to returns and return information without first obtaining a delegation of that authority from the Joint Committee on Internal Revenue Taxation. The Chief of Staff is to have the right to submit any relevant or useful information to any of the tax-writing committees (or duly authorized subcommittees) but only in closed executive session unless the returns and return information would not identify a taxpayer or that taxpayer consented in writing to the disclosure of his identity.

The nontax committees, and designated and duly authorized subcommittees, would be furnished returns and return information in closed executive session upon (1) a committee action approving the decision to request such returns, (2) an authorizing resolution of the House or Senate, as the case may be, and (3) the written request by the Chairman of the committee on behalf of the committee (or on behalf of a subcommittee of such committee) for disclosure of such returns or return information. The resolution of the appropriate body authorizing these committees to obtain returns or return information would specify the purpose for inspection and that inspection was to be made only if there was no alternative source of information reasonably available to the committee (or subcommittee). The committees (or subcommittees), through the committee Chairman and ranking minority member, could designate no more than 4 agents (2 majority and 2 minority) to inspect the returns or return information requested.

The tax-writing committees could submit relevant tax information to the Senate or House, as the case may be. The nontax-writing committees could submit such information to the Senate or House sitting in closed executive session.

The Joint Committee on Internal Revenue Taxation could submit tax information to the Committee on Ways and Means or to the Committee on Finance (or subcommittees thereof) sitting in closed executive session. However, a closed executive session would not be required if a taxpayer were not identified or if the identified taxpayer consented in writing to the disclosure of his identity.

c. White House (and other Federal Agencies)

Present law

The Internal Revenue Code does not provide specifically for disclosure to the President. However, the Code generally provides that disclosure can be made as authorized in rules and regulations established by the President. (Sec. 6103(a).) Under this provision the President could issue a "rule or regulation" providing for his access, and that of White House employees, to tax information. Additionally, in a previous administration, the then-Chief Counsel of the IRS informed the Commissioner in a legal opinion that, as a constitutional matter, there are no restrictions on the Commissioner disclosing tax information to the President. This interpretation was based on that part of the Constitution which vests executive power in the President and, on this basis it was contended that he was entitled to all information relative to his control of the Executive Branch.

President Ford, by executive order, has established rules that govern the disclosure of tax information to the White House. (Executive Order 11805, September 20, 1974.) Under this order, tax returns are available for inspection by the President. Requests for inspection are to be in writing and signed by the President personally. Requests are to state the name and address of the taxpayer in question, the kind of returns which are to be inspected, and the taxable periods covered by the returns.

Under this executive order, other White House employees also may obtain tax information. The order provides that the President may designate, by name, employees of the White House who may receive tax information. This is limited to employees with an annual rate of basic pay at least equal to that prescribed by 5 U.S.C. § 5316 ($37,800 per year, as of October 1, 1975). No further disclosure (except to the President) may be made by such employees without the written direction of the President.

IRS employees who receive a request for tax information from the White House have been instructed to promptly communicate that fact to the Commissioner, through channels. The Commissioner will evaluate the request, and only the Commissioner (or, in his absence, his deputy) is to make the tax information available to the White House. This procedure also applies to "tax checks" on potential Presidential appointees. (IRS Information Notice 74–23, August 9, 1974.)

Generally, there have been three types of tax information provided to the White House. In some cases, tax returns, parts of tax returns, or analyses of tax information with respect to specific individuals have been provided the White House.[8] The White House also receives

[8] For example. John J. Caulfield testified that, while employed at the White House, he received tax information concerning Billy Graham, John Wayne, a number of individuals in the entertainment industry who were "politically active," and an individual working in the re-election campaign of former President Nixon. (Testimony of John J. Caulfield before the Senate Select Committee on Presidential Campaign Activities, March 23, 1974.)

Additionally, Clark Mollenhoff, while a White House employee, received tax information relating to the 1968 Presidential campaign of Governor George Wallace and to income received by his brother, Gerald Wallace. (Affidavit of Clark R. Mollenhoff before the House Committee on the Judiciary, dated June 4, 1974.) Also, Carmine Bellino, formerly special consultant to President Kennedy, received tax returns in 1961 while conducting investigations for the White House (and simultaneously the Justice Department and the Senate Permanent Subcommittee on Investigations of the Government Operations Committee). (*Congressional Record*, April 16, 1970.)

information on "tax checks" of Presidential appointees. Under the current procedure, a tax check on a potential Presidential appointee is initiated by the White House Office as part of a "security and conflicts review" to which the potential appointee consents. As part of this review, the FBI conducts a "full field investigation" which includes checks with various governmental agencies, including the Internal Revenue Service. Therefore, the inquiry to the IRS with respect to a potential Presidential appointee comes directly from the FBI rather than from the White House.

Under the procedure established, only the Commissioner (or, in his absence, the Deputy Commissioner) may authorize disclosure of information under a tax check made for the White House. Additionally, under the Commissioner's procedures, the information provided is limited to whether an individual has filed income tax returns for the immediately preceding three years; owes any unpaid taxes and, if so for what years; has been under any criminal tax investigation and the result of such investigation; or has been assessed a penalty for fraud or negligence. (IR Manual, MT 1272-6 (8-22-74).)

This information is reported to the FBI which in turn reports it to the White House Counsel's Office. The White House Office transmits a report to the President that the security and conflicts review of the potential appointee has either been approved or disapproved. The tax information received by the White House Office is, under present practice, not transmitted to any other office in the White House.

The White House security and conflicts review is used for Presidential appointees, White House staff, some of the Executive Office staff and others who receive a "White House pass" giving them access to the White House and to the President. Tax checks are also made on persons nominated for Department of Commerce "E" Awards (established by Executive Order 10978). In addition to tax checks at the request of the White House, some tax checks are made at the request of other Federal agencies. These checks may be made at the request of the head of the other agency, and apparently also may be made at the request of other agency officers or employees.

Reasons for change

The committee recognizes the President's need for certain tax information, particularly, if not entirely, in the "tax check" area. The committee amendment, to a large extent, codifies President Ford's Executive Order 11805, September 20, 1974, which, among other things, restricts access to tax information to a relatively limited number of people in the White House. Moreover, the committee felt that the White House should report to the Congress regarding the disclosures of tax information made to it. Consequently, annual reporting requirements were imposed upon the White House. Similar requirements were also provided with respect to tax checks made by other Federal agencies.

Explanation of provision

Under the committee amendment upon the written request of the President, signed by him personally, disclosure of return and return information is to be made to the President and/or to certain named employees of the White House Office. A request is to be required to specify the name and address of the taxpayer whose return is sought, the kind of return and return information sought, the taxable period or periods of such returns and return information, and the reason disclosure is requested.

The President and the head of a Federal agency (and their designated employees) also may make a written request for a "tax check" with respect to an individual who is designated as being under consideration for appointment to a position in the Executive or Judicial Branch of the Federal Government. The "tax check" is limited to the inquiry as to whether an individual has filed income tax returns for the last 3 years, has failed in the current or preceding 3 years to pay any tax within 10 days after notice and demand, has been assessed a negligence penalty within this time period, has been or is under any criminal tax investigation (and the results of such investigation), or has been assessed a civil penalty for fraud.

Disclosure of returns and return information under this provision is not to be made to any employee of the White House or Federal agency who does not earn the rate of compensation specified by section 5316 of title 5, United States Code (currently, $37,800 per year). Moreover, these employees will not be allowed to disclose returns and return information to any other person except the President or the head of the agency, as the case may be, without the personal written direction of the President or the head of the agency.

The President and the head of any agency requesting returns and return information under this section will be required to file an annual report with the Joint Committee on Internal Revenue Taxation. This report is to set forth the taxpayers, the returns or return information involved, and the reason for requesting such returns or return information. However, the President will not be required to report on requests for returns and return information pertaining to current employees of the Executive Branch. The reports will not be disclosed unless the Joint Committee on Internal Revenue Taxation determines that disclosure of such reports (or the parts of the reports) would be in the national interest. Thus, if the Joint Committee on Internal Revenue Taxation determined that the President or any Federal agency used the return or return information obtained under this section for improper political purposes, it could determine to make a report of this to the Congress.

The reports will be maintained by the Joint Committee on Internal Revenue Taxation for a period not exceeding 2 years unless, within that period of time, the Joint Committee on Internal Revenue Taxation determines that a disclosure to the Congress is necessary.

d. Tax Cases

Present law

Tax returns and other tax information may be furnished without written application to U.S. Attorneys and Justice Department attorneys in civil or criminal tax cases referred by the IRS to the Justice Department for prosecution or defense. (Regs. § 301.6103(a)-1(h).) Where the Justice Department is investigating a possible violation of the civil or criminal tax laws and the matter has not been referred by the IRS, a Justice Department attorney or U.S. Attorney may obtain tax information upon written application where it is "necessary in the performance of his official duties." (Regs. § 301.6103(a)-1(g).)

The written application must state the name and address of the taxpayer, the kind of tax, the tax period, and the reason inspection is desired. It must be signed by the Attorney General, Deputy Attorney General, an Assistant Attorney General or by a U.S. Attorney.

The Justice Department can obtain the returns of potential witnesses and third parties. Also, in a tax case, (or any other case), the IRS will answer an inquiry from the Justice Department as to whether a prospective juror has been investigated by the IRS. (Regs. § 301.6103(a)-1(h).) However, other tax information is not available for examining prospective jurors.

Tax information obtained by the Justice Department may be used in proceedings conducted by or before any department or establishment of the Federal Government or in which the United States is a party. (Regs. § 301.6103(a)-1(f).)

The Justice Department is responsible for almost all civil and criminal tax matters litigated before the Federal courts (except for the Tax Court).[9] Most civil tax cases handled by the Justice Department involve refund suits by taxpayers where the taxpayer's liability is directly in issue; in refund cases, it is common for the taxpayer to place his tax return in evidence.

Most criminal tax cases generally are based on referrals from the IRS recommending prosecution. In these cases, as well as civil tax cases, the Justice Department is routinely furnished the entire IRS file on the taxpayer.

Tax returns obtained by the Justice Department generally pertain to the taxpayer whose civil or criminal tax liability is directly involved in the case. However, the Justice Department also may obtain directly from the IRS district offices tax returns of potential witnesses for the taxpayer or Government, and third parties with whom the taxpayer has had some transactional or other relationship.

The returns of witnesses generally are obtained for purposes of cross examination and impeachment. In many cases, the information obtained from the witness' tax return is used to cast doubt upon his credibility as a witness, as opposed to establishing the tax liability in issue.

Additionally, in the course of a tax case, the Justice Department may obtain the return of a third party who will not be a witness in the case, but who has had a transactional relationship with the taxpayer involved in the case. In a criminal tax case, third-party returns may be used to develop leads to evidence establishing the guilt of a defendant. In civil tax cases, third-party returns may be used to develop evidence pertaining either directly to the tax liability of a taxpayer, or to impeach the testimony of the party whose tax liability is at issue (or to impeach the testimony of witnesses testifying on his behalf).

The Government also obtains the tax returns of its own witnesses to determine the veracity of their proposed testimony and their credibility in general.

Reasons for change

The committee recognizes the need of the Justice Department to continued access to tax returns and return information in carrying out its statutory responsibility in the civil and criminal tax areas. While

[9] In the U.S. Tax Court, the Commissioner is represented by the Chief Counsel for the IRS.

the committee decided to maintain the present rules pertaining to the disclosure of returns and return information of the taxpayer whose civil and criminal tax liability is at issue, restrictions were imposed in certain instances at the pre-trial and trial levels with respect to the use of third-party returns where, after comparing the minimal benefits derived from the standpoint of tax administration to the potential abuse of privacy, the committee concluded that the particular disclosure involved was unwarranted.

Explanation of provision

The Justice Department would continue to receive returns and return information with respect to the taxpayer whose civil or criminal tax liability was at issue.

The return or return information of a third party would be disclosed to the Justice Department in the event that the treatment of an item reflected on his return is or may be relevant to the resolution of an issue of the taxpayer's liability under the Code. Thus, for example, the returns of subchapter S corporations, partnerships, estates and trusts may reflect the treatment of certain items which may be relevant to the resolution of the taxpayer's liability because of some relationship (i.e., shareholder, partner, beneficiary) of the taxpayer with the corporation, partnership, estate, or trust.

In cases involving the assessment of a penalty upon a person for failure to pay over withholding taxes, the reflection of such items on a corporate return as wages paid, taxes withheld, and the corporate office held by the person, may be relevant to the resolution of the issue of liability for the penalty.

The treatment (or absence of treatment) of alleged loans and gifts on a return may also be relevant to the resolution of the issue in criminal fraud net worth cases.

The return or return information of a third party would also be disclosed to the Justice Department where the third party's return or return information relates or may relate to a transaction between the third party and the taxpayer whose tax liability is or may be at issue and the return information pertaining to that transaction may affect the resolution of an issue of the taxpayer's liability. For example, the treatment on a buyer's return regarding his purchase of a business would be relevant to the seller's tax liability resulting from the sale of the business. The buyer may be amortizing what he claims to be a covenant not to compete, whereas the seller may be claiming capital gain treatment unon the alleged sale of "goodwill."

The return reflecting the compensation paid to an individual by an employer other than the taxpayer whose liability is at issue would not meet either the item or transaction tests described above in a reasonable compensation case. Thus, for example, the reflection on a corporate return of the compensation paid its president would not represent an item the treatment of which was relevant to the liability on an unrelated corporation with respect to the deduction it claims for the salary it paid its president.

In section 482 cases (involving the reallocation of profits and losses among related companies), where it is sometimes necessary to determine the prices paid for certain services and products at arms-length between unrelated companies, the return or return information of a company which was unrelated to the taxpayer company would not be disclosable under either the item or transaction tests described above.

The disclosure of a third party return in a tax proceeding (including the U.S. Tax Court) will be subject to the same item and transactional tests described above, except that such items and transactions must have a direct relationship to the resolution of an issue of the taxpayer's liability.

Only such part or parts of the third party's return or return information which reflects the item or transaction will be subject to disclosure both before and in a tax proceeding. Thus, the return of a third-party witness could not be introduced in a tax proceeding for purposes of discrediting that witness except on the item and transactional grounds stated above.

In those cases where the absence of the reflection of an item or transaction on a third party's return is or may be related (or directly related in a tax proceeding) to the resolution of an issue, the IRS would not be authorized to disclose such return, but would be authorized to verify in a written statement the absence of the reflection of such item or transaction.

The Secretary will have the discretion to refuse to disclose third party return information for purposes of use in a tax proceeding if he determines that such disclosure would identify a confidential informant or seriously impair a pending civil or criminal tax investigation.

Except in those instances where a tax matter was referred by the IRS to the Department of Justice, and tax refund cases under Subchapter B of Chapter 76, the Department of Justice would be required to make a written request (by the Attorney General, the Deputy Attorney General, or an Assistant Attorney General) for the inspection or disclosure of returns and return information, setting forth the reasons for such disclosure or inspection.

In tax cases, the Department of Justice will be allowed to inquire of the IRS as to whether a prospective juror has been under an audit or investigation by the Internal Revenue Service. The Internal Revenue Service will only be allowed to respond affirmatively or negatively to that inquiry. The taxpayer whose civil or criminal tax liability is at issue (and his legal representative) in the case have the same right to this limited disclosure.

e. Federal Agencies—Nontax Criminal Cases

Present law

Under Treasury regulations, a U.S. Attorney or an attorney of the Department of Justice may obtain tax information in any case "where necessary in the performance of his official duties." This may be obtained on written application, giving the name of the taxpayer, the kind of tax involved, the taxable period involved, and the reason inspection is desired. The application is to be signed by the U.S. Attorney involved or by the Attorney General, Deputy Attorney General, or an Assistant Attorney General. (Regs. § 301.6103(a)-1(g).)

Tax information obtained by the Justice Department may be used in proceedings conducted by or before any department or establishment of the Federal Government or in which the United States is a party. (Regs. § 301.6103(a)-1(f).)

The service also will answer an inquiry from the Justice Department as to whether a prospective juror has been investigated by the IRS. (Regs. § 301.6103(a)-1(h).) However, other tax information is not available for examining prospective jurors.

The Organized Crime and Racketeering Section of the Department of Justice coordinates, through Federal Strike Forces, an integrated investigation and prosecution program against organized crime and racketeering activities. These investigations involve the participation of various Federal agencies, including the IRS.

Examples of nontax crimes which a strike force may investigate are counterfeiting and forgery, loan sharking, mail fraud, interstate transportation of stolen property, and illegal payments and loans to labor unions and employees. Tax information may be used to provide strike force investigators leads relating to such criminal activity. Moreover, tax information is used to gather leads or make connections between various individuals and entities. The tax information considered most useful by strike force personnel in its nontax criminal investigation work is that which IRS investigators acquire from parties other than the taxpayeı.

Tax information obtained in strike force investigations is used in prosecuting criminal offenses. Thus, requests are made for tax information pertaining to the defendant, and to defense witnesses in the course of the investigation, at the pretrial level, and sometimes during the trial. The returns of defense witnesses in nontax criminal trials are often requested to obtain information for cross-examination and impeachment of witnesses.

The tax returns of Government witnesses are also obtained in order to evaluate the veracity of their proposed testimony, as well as to evaluate their credibility in general.

Tax information also is obtained with respect to third parties who have had some transactional or other relationship with the defendant in order to seek investigative leads.

During the calendar year 1975, there were 166 requests for tax information by strike forces (and an additional 62 by the Criminal Division) of the Justice Department. The strike force requests concerned 8,103 tax returns of 1,711 taxpayers.

As the chief law enforcement representatives of the Attorney General within their respective judicial districts, U.S. Attorneys are responsible for investigating and prosecuting persons who violate the Federal criminal laws.

U.S. Attorneys use tax information in investigating and prosecuting criminal activities. In calendar year 1975, U.S. Attorneys made 1,350 disclosure requests for tax information. These requests pertained to 17,678 tax returns of 4,330 taxpayers. It appears that a significant proportion of the requests made by U.S. Attorneys are for criminal investigative purposes.

Most U.S. Attorney tax data requests for investigative purposes pertain to potential "white collar" crimes involving some form of corruption (e.g., bribery, illegal kickbacks) or "major fraud" (e.g., bank, investment, and mail frauds). Ordinarily, requests for tax returns are not made with respect to crimes of violence or for routine misdemeanor cases.

In connection with the enforcement of nontax criminal statutes (as well as nontax civil statutes), tax information is available to each executive department and other establishments of the Federal Government (e.g., SEC and FTC) in connection with matters officially before them on the written request of the head of the agency. Tax information obtained in this manner may be used as evidence in any proceedings before any "department or establishment" of the United States or any proceedings in which the United States is a party. (Regs. § 301.6103(a)-1(f).)

Reasons for change

The committee decided that the information that the American citizen is compelled by our tax laws to disclose to the Internal Revenue Service was entitled to essentially the same degree of privacy as those private papers maintained in his home. Present law and practice does not afford him that protection—the Justice Department and other Federal agencies, as a practical matter, being able to obtain that information for nontax purposes almost at their sole discretion.

The committee decided, therefore, that the Justice Department and any other Federal agency responsible for the enforcement of a nontax criminal law should be required to obtain court approval for the inspection of a taxpayer's return or return information. The court approval procedure would not be required, however, with respect to information indicative of a commission of a nontax crime which is derived from a source other than the taxpayer.

Explanation of provision

Under section 6103(i), as amended, disclosure of a return or return information received from a taxpayer, subject to one exception, noted below, would be made to a Federal agency for nontax criminal purposes only upon the grant of an *ex parte* order by a Federal district court judge.

The order would be granted upon the determination of the judge that there is 1) reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed, 2) reason to believe that such return or return information is or may be probative of the commission of such criminal act, and 3) reason to believe that the information sought to be disclosed cannot reasonably be obtained from any other source. Notwithstanding the fact of the reasonable availability of the information from another source, the third requirement described above would be inapplicable if the judge determined that the return or return information sought constituted the best and most probative evidence of the commission of the criminal act.

The first requirement set forth above ("reasonable cause . . .") is intended to be less strict than the "probable cause" standard for issuing a search warrant and this requirement is to be construed according to the plain meaning of the words involved. The term "criminal act" includes any act with respect to which the criminal penalty provisions of the Federal nontax statute (which may also include civil penalty provisions) would apply.

In the case of the Department of Justice, only the Attorney General, the Deputy Attorney General, or an Assistant Attorney General may authorize an application for such an order. In the case of other

Federal agencies, the head of such agency would be required to authorize such an application.

This court procedure contemplates an *in-camera* inspection of the return or return information by the judge to determine whether any part or parts thereof meet the requirements of this section. Only the part or parts of the return or return information determined by the court to be necessary to the investigation or prosecution would be subject to disclosure under this section. In this regard, the committee contemplates that the more personal the information involved (for example, medical and psychiatric information), the more restrictive the court will be in allowing disclosure.

In the event that the Secretary determines that a disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation, he would have the authority to withhold the requested return information from the court order procedure described above. This would be accomplished by a certification by the Secretary to the court of this determination.

The IRS would be precluded under this section from disclosing return information indicating the commission of a crime to the Department of Justice or any other Federal agency where such return information was supplied by the taxpayer or his representative. The Department of Justice and other Federal agencies would only be able to obtain this information through the court approval procedure described above.

The Internal Revenue Service would not, however, be precluded from disclosing to the Department of Justice or any other Federal agency information which is received from sources other than the taxpayer and his representatives. It is contemplated that only in those situations where the information is clearly identified and segregable as being from sources other than the taxpayer would disclosure occur, and only in those instances where such information indicates the possible commission of a nontax Federal crime.

All such information is to be supplied in writing to the Department of Justice and other Federal agencies either upon the initiation of the Commissioner or upon the written request of such agencies. The written request would specify the name of the taxpayer, the kind of tax involved, the taxable period involved, and the reasons why inspection is desired.

Once the Justice Department or any Federal agency has received returns (or parts thereof) or return information pursuant to the court order procedure, further disclosure in an administrative hearing or trial relating to the violation of the nontax criminal law would not be allowed unless there is a showing to the presiding hearing officer or judge that such return information is probative of the commission of the crime. Thus, a return (or parts thereof) or return information would not be admissible for purposes of "collateral impeachment", i.e., discrediting a witness on matters not bearing upon the question of the guilt of the defendant.

As with the initial court order procedure, the Secretary would have the authority to withhold return information from the subsequent criminal trial or hearing upon his determination that the disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation. This authority would apply to return information received under the initial court order procedure and to return information from sources other than the taxpayer furnished by the IRS to the agency. The Secretary would notify the Attorney General or the head of the agency (or their delegates) of the exercise of this authority.

Admission of the return in this proceeding would not, of itself, constitute reversible error in the event of an appeal of the district court's finding in the nontax criminal case. Thus, while the admission of the return in the proceeding would not constitute reversible error because it was admitted into evidence in violation of this provision, it nevertheless may constitute reversible error on grounds,

By this amendment, the committee does not intend to limit the right of an agency (or other party) to obtain returns or return information directly from the taxpayer through the applicable discovery procedures.

f. Nontax Civil Matters—Justice Department and Other Federal Agencies

Present law

Under the regulations, a U.S. Attorney or an attorney of the Justice Department may obtain tax information in nontax civil cases in the same manner and to the same extent as in nontax criminal cases.

The Justice Department has used tax returns in suits brought against the Government seeking money damages for injury or wrongful death. The tax information is used in these cases to verify the claims of loss of income, and also to determine, through claimed medical expense deductions, whether the plaintiff had suffered other injuries before or after the accident in question.

Tax information is also used in suits concerning the renegotiation of Government contracts, where the Renegotiation Board has determined that excess profits were earned on a Government contract. Here, tax information is used to verify the income earned on the contracts in question.

Nontax civil cases also involve affirmative money claims, including civil fraud claims, by the Government against various private parties. In these cases, tax information may be used to determine whether the defendant is financially able to pay the demand contemplated by the Government.

Tax returns are also requested after the Government has obtained a judgment against a party in order to verify statements made by the judgment debtor as to his financial ability to make payment of his debt.

Tax information is available to each executive department and other establishments of the Federal Government in connection with matters officially before them. Information obtained may be used as evidence in proceedings conducted by or before any Federal agency or proceedings to which the United States is a party.

Under the regulations, tax information can be inspected for nontax administration purposes by Treasury employees (who are not in the IRS) on the written request of the head of the appropriate bureau or office. Also, Customs, Secret Service, and other Treasury enforcement agents may obtain limited tax information on their own request, without the request of the head of their office.

Reasons for change

The committee decided that the current use by the Department of Justice and other Federal agencies in the nontax civil cases described above were not warranted in light of the invasions of privacy involved and the fact of the alternative sources of information available to the Department of Justice and other agencies in these situations. However, in one limited instance, the committee decided that the disclosure of returns and return information, particularly since it pertained to corporations in most instances (where the invasion of privacy is not involved) that returns and return information would be disclosed to the Department of Justice in those cases involving renegotiation of contracts where the Department of Justice, in defending the United States in such cases, would use such returns and return information to verify the income earned on the contracts in question.

Explanation of provision

Under the committee amendment, disclosure of returns and return information could be made to the Department of Justice in those instances where the Department of Justice was defending the United States in a suit involving a renegotiation of contracts case previously determined by the Renegotiation Board.

The committee amendment would not permit disclosure to Treasury personnel (other than employees of the IRS) of returns or return information for purposes other than tax administration or statistical use.

By this amendment, the committee does not itnend to limit the right of an agency (or other party) to obtain returns or return information directly from the taxpayer through the applicable discovery procedures.

g. Statistical Use

Present law

Several agencies obtain information from tax returns for statistical purposes. Under regulations allowing general inspection of tax information, the Department of Commerce (Census Bureau and Bureau of Economic Analysis) is authorized to use information from tax returns for statistical purposes (Reg. § 301.6103(a)–104). The Federal Trade Commission (Reg. § 301.6103(a)–106) and the Securities and Exchange Commission (Reg. § 301.6103(a)–102) also are authorized to use information for statistical purposes.

Census Bureau.—The most extensive user of tax information for statistical purposes is the Census Bureau, within the Department of Commerce.[10] In most cases the Census Bureau does not obtain the full tax returns. The Bureau uses information from tax returns to assist in preparing the Economic Indicators, the Survey of Minority-owned

[10] For e-ample, in 1975, the following income tax return records were transferred to the Census Bureau:

1. 8.400.000 Business Master File Entity Change Records showing employer identification number (EIN). name, address, and zip code.
2. 21.200.000 Forms 941 showing EIN, total compensation, FICA wages, taxable tips, master file account, tax period, and address change.

Business Enterprises, and the Survey of County Business Patterns. The Economic Census (conducted every five years) is used for the Index of Industrial Production (of the Federal Reserve Board), the Index of Wholesale Prices (of the Bureau of Labor Statistics), and the Gross National Product accounts. The Current Economic Indicators include information on retail sales, manufacturers' shipments, orders and inventories, investment, and are used for the Index of Industrial Production (Federal Reserve Board). These statistics are used as a basis for national economic policy, for distributing funds by agencies, by State and local governments in determining their programs, and by private business in forecasting, marketing, investment, etc.

In general, these statistics are not based on data from tax returns. Instead, information from tax returns is used by the Census Bureau to prepare lists of persons to be surveyed by the Bureau to tabulate statistical links between data reported by the Service and the Census Bureau, to excuse smaller firms from filing reports (by using data from tax returns instead), and to weed out firms that do not need to report.

The Census Bureau has made an analysis of the effect of not allowing it to use tax data. Generally, the Bureau has stated that the effect of entirely prohibiting it from having access to information from tax returns would be to significantly increase the costs of collecting data and to significantly decrease the quality of the statistics developed.

The Census Bureau also uses "relatively small samples of individual tax records," on a case-by-case basis, to compare income reported in tax returns with income reported in the census. Similar evaluation studies are used by the Bureau in connection with surveys such as the Current Population Survey.

Information from tax returns is also used by the Bureau in determining amounts to be allocated under revenue sharing; this use was specifically contemplated by the Congress in establishing the revenue sharing program (see General Explanation of the State and Local Fiscal Assistance Act, H.R. 14370, 92nd Congress, Public Law 92–512, page 39 (Feb. 12, 1973).)

Bureau of Economic Analysis.—The Bureau of Economic Analysis (BEA) prepares the National Income Accounts, including the National Income and Product Accounts focusing on GNP, and the Balance of Payments Accounts. BEA has stated that a major input into GNP is the IRS published Statistics of Income series. However, BEA has also stated that it needs access to a sample of individual large corporation's tax returns to prepare "industry extrapolators," and to be able to distinguish changes in the IRS Statistics of Income series that occur on account of shifts in economic development from changes that occur on account of shifts in tax reporting.

BEA obtains tax information from returns of large corporations. It does not obtain tax information from returns of individuals. Generally, BEA employees examine IRS transcript cards that summarize information from 500 to 1,000 returns of the largest corporations. (In calendar year 1974, BEA obtained 300 "transcript-edit sheets" of corporate returns.) BEA employees copy data from these cards and also inspect 20 to 100 tax returns over the course of a year.

Federal Trade Commission.—The Federal Trade Commission obtains tax information for use in the Industrial and Financial Reports Program and the Quarterly Financial Report series.[11]

For the most part, the FTC does not need detailed financial information from the IRS. It does not use information about individuals. The FTC uses the information it receives to develop a sample of corporations which it then surveys. To develop this sample, the FTC needs the following information: name, address, EIN, industry code, sample code, and gross assets indicator. The "industry code" tells what the principal industrial activity of the corporation is. The "sample code" tells the sampling process used by the IRS with respect to its Statistics of Income (not with respect to audit, etc.), and does not appear to be tax information. A gross assets indicator would tell, e.g., whether the corporation had gross assets of over $10 million, $5–$10 million, $3–$5 million, $1–$3 million, or less than $1 million. Other information, such as the accounting period and the consolidated return indicator, are helpful to the FTC in developing more accurate statistics, but are not basic to its statistical process.

Securities and Exchange Commission.—The SEC has not obtained tax information for statistical purposes for several years, since the functions for which the SEC required this information were moved to the Federal Trade Commission.

Reasons for change

The committee recognizes the importance to other Federal agencies to be allowed the use of returns and return information in connection with certain of their statistical and research functions. Since there does not appear to be any real likelihood that the use of returns and return information by these agencies would, under the procedures and safeguards provided for in this amendment, result in an abuse of the privacy or other rights of the taxpayers whose returns and return information is used, the committee decided that the use of returns and return information should be available for statistical use by certain agencies other than the IRS.

Explanation of provision

Under the amendment, the Census Bureau, the Bureau of Economic Analysis, and the Federal Trade Commission could obtain tax returns and limited tax information solely for statistical and research purposes authorized by law, but only such tax information as is necessary to carry out those statistical and research activities. The Federal Trade Commission and the Bureau of Economic Analysis would only be entitled to receive corporate tax information.

In addition, returns and return information would be open to inspection by, or disclosure to, officers and employees of the Department of the Treasury (other than officers and employees of the In-

[11] The Federal Trade Commission obtained the following tax information in 1974 (the 1975 data are not yet available):

1. 58.729 specially prepared abstract sheets for corporation returns.
2. 43.000 Forms 1120. etc., including name, address, EIN. date incorporated, gross receipts, taxable income. total assets. industry code, accounting period, and name, address and EIN of consolidated subsidiaries.
3. 31,000 abstracts of corporate tax returns showing name, address, zip code, EIN, date incorporated. gross receipts. taxable income. total assets, industry code, accounting period, and name, address, and EIN of consolidated subsidiaries.

ternal Revenue Service) whose official duties require such inspection or disclosure for purposes of preparing economic or financial forecasts, projections, analyses, and statistical studies and conducting related activities. Inspection or disclosure would be permitted only upon a written request setting forth the specific reason or reasons why such inspection or disclosure is desired and signed by the head of the bureau or office of the Department of the Treasury requesting the inspection or disclosure.

Treasury regulations would specify the limited types of tax information (e.g., name, address, social security number, gross receipts, etc.) which would be supplied to each agency under this provision. The publication of any statistical study which would identify any particular taxpayer would be prohibited.

h. Other Agencies—Inspection on a General Basis

Present law

Under the regulations, several agencies may generally inspect tax information for qualified purposes, without the head of the agency having to write a specific request to the IRS identifying the taxpayer and the reason for the desired inspection. Inspection of tax information on a general basis is made most often by the Department of Health, Education, and Welfare, the Renegotiation Board and the Federal Trade Commission.

The Department of Health, Education, and Welfare may inspect individual tax returns as required to administer Title II of the Social Security Act (old-age, survivor, etc., benefits). Inspection is authorized on the written application of any authorized officer or employee of the department. (Reg. § 301.6103(a)-100.) In calendar year 1974, the Social Security Administration was furnished 6,633 returns for administering Title II of the Social Security Act. In most cases tax data are requested by the Social Security Administration to obtain evidence of earnings so that an individual's entitlement to monthly benefits may be properly determined. This information can be used to the benefit of the individual or to the benefit of the government with respect to determining Social Security benefits. In addition, 27,000,000 employment tax schedules are furnished annually to the Social Security Administration for purposes of administering the Social Security Act.

The Renegotiation Board is authorized to obtain income tax information "in the interest of the internal management of the government." The Renegotiation Board is charged with administering the laws to renegotiate contracts with government contractors to eliminate excess profits. (Reg. § 301.6103(a)-105.) In 1974 the Renegotiation Board was furnished 1,803 transcripts (i.e., abstracts of corporation tax returns), including information on the taxpayer's gross receipts, taxable income, accounting period, identification of related companies, etc. The Renegotiation Board uses tax information to determine whether excessive profits have been derived from contracts and related subcontracts made with the United States.

The Federal Trade Commission is authorized to obtain income tax information of corporations "as an aid in executing the powers conferred upon such Commission by the Federal Trade Commission Act."

Any authorized officer or employee of the FTC may make inspection. (Reg. § 301.6103(a)-106.)

Reasons for change

The committee decided that in many situations the current use of returns and return information on a general basis is not warranted. The committee decided to limit strictly the types of returns and return information which would be made available to other agencies on a general basis for purposes other than tax administration or statistical use, and the situations in which they would be made available. Generally, these are situations where the return information is directly related to programs administered by the agency in question.

Explanation of provisions

The committee amendment would permit limited disclosures on a general basis to the Social Security Administration, the Railroad Retirement Board, the Department of Labor, the Pension Benefit Guaranty Corporation and the Renegotiation Board for purposes other than tax administration. Under this provision, disclosure would be made to officers and employees of the receiving agency who are duly authorized and specifically designated in writing by the receiving agency to receive the returns or return information. The disclosure would be made without the requirement of a written request specifying the particular returns or return information desired.

The committee amendment would permit the Social Security Administration to obtain returns and return information concerning employment taxes for purposes of the administration of the Social Security Act. Also, the Railroad Retirement Board could obtain returns and return information with respect to railroad retirement taxes. The Internal Revenue Service would also be authorized to furnish certain returns and limited return information to designated officers and employees of the Department of Labor and the Pension Benefit Guaranty Corporation for purposes of the administration of the pension reform act (the Employee Retirement Income Security Act of 1974). In addition, as provided in the pension reform act, copies of annual registration statements of employee benefit plans and related information concerning vested benefits of employees could be furnished to the Social Security Administration.

Under the committee amendment, the Renegotiation Board could, upon the written request of its chairman, continue to receive returns and return information with respect to the income tax for purposes of administering the Renegotiation Act. The returns and return information so provided would be open to duly authorized and specifically designated officers and employees of the Board personally and directly engaged in, and solely for their use in, verifying or analyzing financial information required by the Renegotiation Act to be filed with, or otherwise disclosed to the Board, or to the extent necessary to implement the provision in the Code relating to the mitigation of the effect of the renegotiation of government contracts (sections 1481 and 1482).

The Renegotiation Board, through its chairman, would be allowed to disclose these returns and return information to the Justice Department upon a referral of one of its cases to this agency for further legal action.

i. State and Local Governments

Present law

On the written request of the State governor, individuals' and organizations' tax returns may be inspected by State tax officials for purposes of administering the State's tax laws. At the governor's written request, tax information also may be obtained for local governments to be used in administering their tax laws. (Sec. 6103(b).) Income tax information is not furnished directly by the IRS to local governments. Instead, State tax officials furnish such information to local governments where the IRS has approved such action at the request of the Governor.

Under the regulations, with the permission of the Commissioner and for purposes of State tax administration, a State may be allowed to inspect on a general basis all income, estate, and gift tax returns filed in the district in which the State is located. The same is true for other types of returns such as estate tax and gift tax returns. Additionally, the specifically identified returns of taxpayers who filed within the relevant district, and of taxpayers who filed in districts which do not include the State in question, may be inspected on a case-by-case basis on the written request of the State Governor.

On request, the Commissioner may allow each State to inspect on a general basis all tax returns filed by residents of the State. The ability to inspect returns under this procedure applies to the physical inspection of the documents in question.

The States may also enter into tax coordination agreements with the IRS with respect to inspection of tax information. (These agreements generally provide for cooperation between the IRS and the States in tax administration, for an exchange of tax information, for assistance in locating delinquent taxpayers (and their property), and for cooperative audits, and also provide for preserving the confidentiality of tax information.[12]

By far the largest IRS/State information exchange program, in terms of amounts of information transferred, is the furnishing of Federal tax information on magnetic tape. In 1975, 48 States (plus the District of Columbia, American Samoa, Guam, and Puerto Rico) participated in this program. Under the 1975 Individual Master File (IMF) program, information on nearly 66 million taxpayers was provided to the States. (This covers approximately 80 percent of individual taxpayer records.) IMF tax data available to the States include: name, address, social security number, filing status, tax period, exemptions claimed, wages and salaries, adjusted gross income, interest income, taxable dividends, total tax, and audit adjustment amount. Under the tape exchange programs, the States agree to conduct a joint review with the IRS of safeguards of tax information.

A Business Master File (BMF) program is also available to the States to aid them in establishing their own business master files. Information from the Exempt Organization Master File is also available to the States, as is gift tax data.

Under the cooperative audit program, copies of examination reports are furnished the States. In 1974, nearly 700,000 abstracts of these

[12] A State is not precluded from inspecting tax information if it has not entered into an agreement.

reports were furnished the States. (The 1975 figures are not available.) Also, the IRS furnishes the States information on returns that appear to have good audit potential but will not be audited by IRS because of manpower restrictions. In 1974, information was furnished on more than 70,000 returns under this program. (The 1975 figures are not available.)

Reasons for change

It has been suggested that tax information that is supplied to tax officials at the State and local levels may not be invariably subject to appropriate safeguards on confidentiality. Also, it has been suggested that political considerations may produce unwarranted interest by State and local governments in tax information for nontax purposes.

IRS studies have indicated that in several situations, State authorities have allowed other States (or local governments) to inspect Federal tax information, have not maintained adequate records of inspection of Federal tax information, and have inadequate procedures to instruct employees with respect to Federal tax return confidentiality. However, it is understood that when these problems have been brought to the attention of the State authorities involved, remedial action has been taken.

However, the committee feels that it is important that the States continue to have access to Federal tax information. With Federal tax information, the States are able to determine if there are discrepancies between the State and Federal returns in, *e.g.*, reported income. Also, many States have only a few, if any, of their own tax auditors and rely largely (or entirely) on information concerning Federal enforcement in enforcing their own tax laws.

Explanation of provision

The committee amendment authorizes, upon the written request of the principal tax official of the State (other than the Governor), the disclosure of income, estate, gift, social security (FICA), unemployment (FUTA), self-employment (SECA), withholding, alcohol, tobacco, and highway use tax returns and return information solely for the purpose of, and only to the extent necessary in, the administration of the State's tax laws. It is intended that regulations be issued specifying the manner in which and the conditions under which returns and return information would be disclosed to State tax officials.

The returns and return information would only be open to inspection by or disclosure to those duly authorized representatives of a State agency, body, or commission charged with the responsibility of the administration of State tax laws who are designated in the written request as the individuals who are to inspect or receive the returns or return information on behalf of the agency, body, or commission. The returns and return information so disclosed would not be available to the State Governor or any other nontax personnel. The prohibition against disclosure of Federal returns and return information to the State Governor would apply even in those situations where the Governor, under State law, is considered to be the principal tax official of the State.

As in the case of returns and return information disclosed to other agencies, the unauthorized disclosure by State tax officials of Federal returns or return information would be a violation of Federal law subject to civil liability and criminal penalties.

Return information would not be disclosed to a State in the event the Secretary determined that the disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

The general authority provided to the IRS by this amendment (see the discussion below of Procedures and Safeguards) to require recipients of Federal returns and return information to maintain adequate procedures for safeguarding the Federal returns and return information would also apply with respect to the States. In addition, the amendment provides that no return or return information is to be disclosed after December 31, 1978, to any official or employee of any State which requires a taxpayer to attach to, or include in, any State tax return a copy of any portion of his Federal return (or any information set forth or disclosed in his Federal return), unless the State adopts provisions of law which protect the confidentiality of the return or return information. Thus, the IRS is authorized to take such steps as it considers necessary, including the withholding of further Federal returns and return information (subject to the administrative appeal procedure; see, Safeguards below), in the event the State did not maintain adequate safeguards for, or in the event of unauthorized disclosures of, Federal returns and return information. It is intended that this authority should be broadly construed to cover disclosures of, and the failure to maintain adequate safeguards for, State returns and return information or other information, to the extent disclosures of such information might indirectly jeopardize the confidentiality of the Federal return or return information furnished to the States.

The committee amendment would not permit the disclosure of Federal returns and return information (other than information with respect to tax return preparers as described below) to local tax authorities, either directly by the IRS or indirectly by the State tax authorities. However, the committee did not intend by this decison to limit the disclosure by State tax officials to local tax authorities of State tax returns and return information. For this purpose, State return information which could be disclosed to local tax authorities would include information resulting from tax audits and investigations conducted by State tax authorities, even where that information is based on or is substantially similar to Federal return information supplied or made available to the State tax authorities. It would not, of course, be permissible for State tax officials merely to transcribe Federal return information, designate it as State tax information, and furnish it to local tax authorities as information resulting from a state tax audit investigation.

Moreover, under the general authority of the IRS to require States to maintain adequate procedures for safeguarding Federal returns and return information, the IRS could take such steps as it considers necessary, including withholding Federal returns and return information from the States, in any situation where it finds that disclosures of, or the failure to maintain adequate safeguards for, such State return information furnished to local tax authorities may have the result of jeopardizing the confidentiality of the Federal return information.

In addition, taxpayer identity information (name, mailing address, and taxpayer identifying number) of any tax return preparer (as defined in section 7701(a)(36)) could be disclosed to any State or local agency, body, or commission charged with licensing, registration, or regulation of tax return preparers. The fact of any penalty imposed on a tax return preparer under sections 6694, 6695, or 7216 for the unlawful disclosure or use of tax information could also be disclosed.

j. Taxpayers With a Material Interest

Present law

Under the regulations, income tax returns presently are open to the filing taxpayer, trust beneficiaries, partners, heirs of the decedent, etc. "Return information", as opposed to the tax returns themselves, is only available to the taxpayer, etc., at the discretion of the IRS.

Also, the statute specifically authorizes the inspection of a corporation's income tax returns by a holder of 1 percent or more of the corporation's stock. (Sec. 6103(c).)

Reasons for change

The committee decided that persons with a material interest should continue to have the right to inspect returns and, where appropriate, return information to the same extent as provided under current regulations.

Explanation of provision

Under the committee amendment, disclosure could be made, upon written request, to the filing taxpayer, either spouse who filed a joint return, the partners of a partnership, the shareholders of subchapter S corporations, the administrator, executor or trustee of an estate (and the heirs of the estate with a material interest that may be affected by the information), the trustee of a trust (and beneficiaries with a material interest), persons authorized to act on behalf of a dissolved corporation, a receiver or trustee in bankruptcy, and the committee, trustee or guardian of an incompetent taxpayer.

The provision in present law authorizing a one percent shareholder to inspect a corporation's return would also be retained.

Return information (in contrast to "returns") could be disclosed to persons with a material interest only to the extent the IRS determines this would not adversely affect the administration of the tax laws.

k. Miscellaneous Disclosures

Present law

Under present law, several provisions of the regulations allow disclosure of tax information for miscellaneous administrative and other purposes. For example, accepted offers in compromise (under sec. 7122) are open to inspection. Internal Revenue officers may disclose limited information to verify a deduction, etc. Additionally, in a number of cases, tax information may be disclosed at the discretion of the Commissioner, as the statute is wholly silent with respect to certain types of returns. For example, FICA tax returns are within this category.

In other cases, the statute specifically requires public disclosure of certain types of returns. Under the Code, applications for exempt status by organizations and applications for qualification of pension, etc., plans are generally open to public inspection. (Sec. 6104(a).) Also, the annual reports of private foundations are open to public inspection. (Sec. 6104(d).) Returns with respect to the taxes on gasoline and lubricating oils are open to inspection by State officials. (Sec. 4102.) Under certain circumstances, the amount of an outstanding tax lien may be disclosed. (Sec. 6323(f).)

Upon inquiry, the IRS is to disclose whether any person has filed an income tax return for the year in question. (Sec. 6103(f).) Inquiries under section 6103(f) are made by, among others, news media and commercial concerns.

Additionally, the IRS sometimes is asked to provide information concerning a taxpayer's address. Address information will be provided to State or local officials for tax administration purposes, to State or local enforcement officials if furnishing the information will aid in Federal special enforcement programs (*e.g.*, narcotics programs), to Federal agencies in general to assist in administering their responsibilities and to "educational lending institutions" to locate delinquent borrowers under Federal loan guarantees. Address information will not, however, be provided to commercial concerns. Also, address information is provided to the Federal Parent Locator Service regarding "absent parents" under Public Law 93-647 (section 453 of the Social Security Act). Address information also may be provided individuals in emergency situations.

Reasons for change

The committee decided that it was necessary to allow the disclosure of returns and return information in certain miscellaneous situations. In most of these situations, disclosure is permitted under present law. In each situation, the committee decided either that the returns or return information should be public as a matter of policy, or that the reasons for the limited disclosures involved outweighed any possible invasion of the taxpayer's privacy which might result from the disclosure.

Explanation of provision

Returns would continue to be open to public inspection in those situations where public disclosure is provided for in present law under section 6104. This includes applications for exempt status by organizations, applications for qualification of pension, etc. plans, the annual reports of private foundations, and returns filed with respect to the excise taxes imposed on private foundations and pension plans (under chapters 42 and 43).

Return information would be disclosed to members of the general public to the extent necessary to permit inspection of any accepted offer-in-compromise under section 7122. If a notice of lien has been filed (pursuant to section 6323(f)), the amount of the outstanding obligation secured by the lien is authorized to be disclosed as a matter of public record and may be disclosed to any person who furnishes satisfactory written evidence that he has a right in the property subject to such lien or intends to obtain a right in such property. Disclosures to foreign governments would be authorized to the extent provided for in tax treaties.

Disclosure would be made to the General Accounting Office in accordance with the committee's prior decision to order H.R. 8948 reported favorably, as amended by the committee. This would permit the General Accounting Office to audit the Internal Revenue Service and the Bureau of Alcohol, Tobacco and Firearms, and would provide access to tax returns and tax return information in connection with such audits. The committee amendment would limit access to tax returns and tax return information to the instances where prior consent has been obtained from, and the audit is conducted under the supervision of, the Ways and Means Committee, the Finance Committee, or the Joint Committee on Internal Revenue Taxation.

Alcohol, tobacco, wagering and firearms tax information could be disclosed pursuant to Treasury regulations to Federal agencies that require this information in their official duties.

Returns and return information of taxpayers and spouses could be disclosed to appropriate Federal, State, and local agencies for purposes of, and only to the extent necessary in, locating deserting parents and determining ability to make support payments.

The committee amendment authorizes the IRS, upon written request, to disclose returns and return information to the Privacy Protection Study Commission, or to such members, officers, or employees of the commission as may be named in the written request, to the extent, and for such purposes, as provided by section 5 of the Privacy Act of 1974.

The IRS would be authorized to disclose, to the extent necessary for purposes of tax administration, returns and return information to any person with respect to his performance of services in connection with the processing, storage, transmission, or reproduction of returns and return information or in connection with the programming, maintenance, repair, testing, and procurement of equipment.

Disclosures to the press and other media is to be permitted for purposes of notifying a person entitled to a Federal tax refund when, after reasonable time and effort, the IRS is unable to locate the person.

The IRS would be authorized to disclose relevant returns and return information to an employee (or former employee) of the IRS and to his attorney in an adverse proceeding against the employee. This need for limited disclosures arises, for example, in proceedings brought against the employee for harassment of a taxpayer.

Disclosures, as necessary, would also be permitted to persons (and their legal representatives) whose rights to practice before the IRS may be affected by an administrative action or proceeding.

Under the committee amendment, the Secretary may, in his discretion but only following approval by the Joint Committee on Internal Revenue Taxation, disclose, as he considers advisable for purposes of tax administration, such return information or other information with respect to any specified taxpayer to the extent necessary to correct a misstatement of fact published or disclosed with respect to such taxpayer's return or dealing with the IRS.

IRS officials and employees would be permitted, if no reasonable alternative exists, to make limited disclosures of return information in connection with an audit or investigation to the extent necessary in arriving at a correct determination of tax, liability for tax, or the amount to be collected, or otherwise in the enforcement of any provision in the Code.

In certain instances, it may be necessary for IRS personnel, in obtaining information with respect to a taxpayer from a third party, to disclose the fact that the request for information is in connection with an audit or other tax investigation of the taxpayer. In rare and extraordinary cases, it may also be necessary for IRS personnel in obtaining information from a third party to disclose additional return information, such as the manner in which the taxpayer treated on his return a transaction with the third party. Disclosures under this provision are to be made only in situations and under conditions specified in the regulations. This provision is not intended to permit disclosure which would not be permitted under current law. *Ct.* Rev. Rul. 58–120, 1958–1 Cum. Bull. 498.

Certain miscellaneous disclosures provided for in present law would no longer be authorized. For instance, the provision in present law authorizing the IRS to disclose, upon inquiry, whether a person has filed an income tax return for a particular year, would be repealed.

l. Procedures and Records Concerning Disclosure

Present law

Several different offices of the IRS have responsibility for approving disclosure of tax information to particular agencies. For example, the Disclosure Staff (National Office) deals with case-by-case requests for tax returns by other Federal agencies while the Statistics Division deals with the disclosure of information to Federal agencies (largely on magnetic tape) to be used for statistical purposes. Additionally, the Planning and Research Division deals with disclosure of information on magnetic tape to the States while the Disclosure Staff deals with case-by-case disclosure to the States.

While these offices negotiate and approve disclosures of tax information, the actual transfer of the information generally takes place in other offices, such as the Service Centers, District Office, Computer Center, etc. In addition, District Directors and Service Center Directors are authorized to approve applications for certain types of disclosure, such as disclosure to persons with a material interest in the returns, and returns of the taxpayer (in tax cases) to U.S. attorneys.

The IRS presently maintains records concerning disclosure. However, it is understood that the type of records maintained are not standardized as between, e.g., Service Centers, and that the IRS does not maintain a complete inventory of records so, for example, it cannot determine what has been disclosed and what has been returned or destroyed.

Under the Privacy Act of 1974 (P.L. 93–579), each Federal agency is to account for disclosures to other agencies, noting the date, nature, and purpose of each disclosure and the name and address of the agency to which disclosure is made. This rule does not apply to disclosures by State agencies. The accounting is designed to enable the agency to inform the individual concerned of disclosures made with respect to him.

Reasons for change

Recently, there have been reports that tax information improperly transferred outside the IRS.

There does not presently appear to be a standardized system of accounting for disclosure which would permit the IRS to determine what information has been transferred, for what purposes, what use has been made of it, and whether it has been destroyed, returned, etc., after it has been used. Also, studies indicate that in several situations, inadequate records have been maintained of transfer of tax information to the various Federal agencies and to State authorities and that in certain instances IRS procedures have not been properly followed.

Explanation of provision

In those cases in which disclosure or inspection of returns and return information would be permitted by the amendment, it would be permitted only at the times, in the manner, and at the places prescribed by Treasury regulations.

It is intended that, to the extent practical, all disclosures of return information be made in documentary form in order to protect the privacy of the taxpayer and to protect the IRS personnel making the disclosure from subsequent charges that information was improperly disclosed. Disclosure in documentary form would serve to preserve an exact record of the information disclosed so as to make it possible to determine, should the question arise, whether an unauthorized disclosure of information had been made. The committee recognizes, however, that it may not be possible or practical in every instance for return information to be disclosed in documentary form (e.g., discussions between IRS personnel and Justice Department attorneys with respect to a pending tax case being handled by the Justice Department).

The amendment requires the IRS to maintain a standardized system of permanent records on the use and disclosure of returns and return information. This would include copies of all requests for inspection or disclosure of returns or return information and a record of all inspections and disclosures of returns and return information. In the case of the inspection or disclosure of documentary information, such as a return, which the IRS retains in some form in its records either permanently or for a substantial period (e.g., 10 years), the record of the inspection or disclosure would include an identification of the document, or part thereof, disclosed or inspected. In the case of inspections or disclosures of documents which the IRS would not otherwise retain for a substantial period, the record should contain a copy of the document.

The recordkeeping requirements would not apply in certain situations, including disclosure of returns and return information open to the public generally (accepted offers-in-compromise, the amounts of outstanding tax liens, information returns of exempt organizations, etc.), disclosures to the Treasury or the Justice Department for tax administration and litigation purposes, disclosures to persons with a material interest, disclosures to persons upon the taxpayer's written consent, disclosures to the media of taxpayer identity information and disclosures to contractors who perform processing, storage, transmission, reproduction, programming, maintenance, testing, or procurement of equipment services for the IRS. The amendment would also make it clear that the IRS is not required to disclose to taxpayers under the Privacy Act any disclosures made to the persons and agencies with respect to which the recordkeeping requirements do not apply. In addition, the committee amendment makes it clear that the recordkeeping requirements of the Privacy Act cannot be utilized to resolve substantive tax disputes.

The amendment requires the IRS to establish one office which would have the responsibility for approving all inspections and disclosures of returns and return information. However, upon approval of that office, disclosure of tax returns could be made by district offices where appropriate and to the extent provided for in regulations. In addition, authority could be delegated to the district offices on a general basis with respect to disclosures or inspections of returns and return information open to the public generally.

In addition to the recordkeeping requirements imposed on the IRS, the amendment provides that each Federal and State agency that receives tax information would be required, pursuant toTreasury regulations, to maintain a standardized system of permanent records on the use and disclosure of that information. Maintaining such records would be a prerequisite to obtaining and continuing to receive tax information.

m. Safeguards

Present law

Except for the general criminal penalty for unauthorized disclosure, the tax law does not provide rules for safeguarding tax information disclosed by the IRS to other agencies. However, some of the existing Agreements on Coordination of Tax Administration entered into between the Federal Governent and the States include provisions for safeguarding tax information.

The Privacy Act requires that each agency establish appropriate administrative, technical, and physical safeguards to secure records on individuals. This requirement applies to each Federal agency that maintains a "system of records". This provision does not apply to State or local government agencies that receive Federal tax records.

The IRS has no authority under the Privacy Act to audit the safeguards established by other agencies, or to stop disclosure to other agencies that do not properly maintain safeguards.

Reasons for change

The committee decided that, although it is necessary to permit the disclosure of Federal returns and return information to other Federal and State agencies in certain situations for purposes other than the administration of the Federal tax laws, no such disclosure should be made unless the recipient agency complies with a comprehensive system of administrative, technical, and physical safeguards designed to protect the confidentiality of the returns and return information and to make certain that they are not used for purposes other than the purposes for which they were disclosed.

Explanation of provision

The committee amendment provides that no tax information would be furnished by the IRS to another agency (including commissions, States, etc.) unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives. Disclosure of tax information to other agencies would be conditioned on the recipient maintaining a secure place for storing the information, restricting access to the information to people whose duty requires access and to people to whom disclosure can be made under the law, providing other safeguards necessary to keeping the information confidential, and returning or destroying the information when the agency is finished with it. The amendment specifically authorizes regulations allowing the IRS to carry out these provisions.

If there are any unauthorized disclosures by employees of the other agency, disclosure of tax information to that agency could be discontinued until the IRS is satisfied that adequate protective measures have been taken to prevent a repetition of the unauthorized disclosure. In addition the IRS could terminate disclosure to any agency if the IRS determines that adequate safeguards are not being maintained by the agency in question. In this connection, the amendment requires that an administrative procedure be established by regulations under which the States would, under appropriate circumstances, have an opportunity, prior to the cut-off of returns and return information, to contest a preliminary finding by the IRS of inadequate safeguards or unauthorized disclosures, or to establish that steps had been taken which would prevent a repetition of the violation.

The IRS is to review, on a regular basis, safeguards established by other agencies.

The authority of the IRS with respect to safeguarding the confidentiality of returns and return information furnished to other agencies is intended to be sufficiently broad to permit the IRS to take such steps, pursuant to regulations, as are necessary to prevent indirect disclosures of return information. Indirect disclosures might include disclosures by recipient agencies of information received by the agency from sources other than the IRS which is the same or substantially the same as return information furnished to that agency by the IRS, where that disclosure would conflict with the congressional policy expressed by this amendment of protecting the confidentiality of returns and return information.

n. Reports to Congress

Present law

Since 1971 the Joint Committee on Internal Revenue Taxation has received from the IRS a semi-annual report on disclosure of tax information.

Reasons for change

Because the use of returns and return information for purposes other than tax administration has resulted in serious abuses of the rights of taxpayers in the past, and because the potential for abuse necessarily exists in any situation in which returns and return information are disclosed by the IRS to other Federal agencies and the States for purposes other than the administration of the Federal tax laws, the committee believes that it is necessary for Congress to review very closely the use of returns and return information and the extent to which taxpayer privacy is being protected. In order to permit that review, the committee decided to require that the IRS make certain comprehensive annual reports to the Joint Committee as to the use of returns and return information.

Explanation of provision

Within 90 days after the end of each calendar year, the IRS would be required to report to the Joint Committee on Internal Revenue Taxation on all requests (and the reasons therefor) received for inspection or disclosure of returns or return information. The report would not include, however, a listing of any requests by the President for returns or return information with respect to current employees of the Executive Branch. The report would be confidential unless a majority of the members of the Joint Committee agree by record vote to disclose all or any portion of the report. The report would include, as a separate section which would be publicly disclosed in all cases, a listing of all agencies receiving tax return information, the number of cases in which a tax return or tax return information was disclosed to them during the year, and the general purposes for which the requests were made.

Included in the report to the Joint Committee would be a listing of all requests for tax-checks of current employees of the Executive Branch (other than such requests made by the President), and all requests for tax-checks made by the President or the head of a Federal agency with respect to prospective employees. The listing should set forth the reasons for each request, the taxpayer involved, and the particular returns and return information disclosed. This portion of the report would also be confidential and would not be disclosed unless the Joint Committee determines that disclosure would be in the national interest.

The IRS would be required to report quarterly to the tax committees on the procedures established for maintaining the confidentiality of tax information disclosed outside the IRS, on the implementation of these procedures, and on any problems that may develop in connection with these procedures.

o. Enforcement

Present law

Unauthorized disclosure of a Federal income return, or financial information appearing on an income return (the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return), by a Federal or State employee is a misdemeanor punishable by a fine of up to $1,000, or imprisonment of up to one year, or both (together with the costs of prosecution). Federal officers or employees also are to be dismissed from office or discharged from employment. I t also is a misdemeanor (punishable in the same manner) for any person to print or publish in any manner not provided by law an income return or financial information appearing therein. (Sec. 7213(a) (1), (2), see also 18 U.S.C. § 1905.)

Shareholders who are permitted under section 6103(c) to examine a corporate return are guilty of a misdemeanor (punishable as above) if they disclose in any manner not provided by law the amount of any income, etc., shown on the return.

The IRS has conducted investigations concerning the possible improper disclosure of confidential information as follows:

	Fiscal year—		
	1973	1974	1975
Investigations conducted	58	103	179
Disciplinary actions	9	23	23
Separations from employment	4	2	5

There have also been criminal prosecutions for illegal disclosure of confidential tax information, as follows:

	Fiscal year—		
	1973	1974	1975
Prosecution referrals	8	8	4
Prosecutions declined	7	5	4
Convictions	1	3	0

Two of the four people convicted were IRS employees and two were private detectives. The two IRS employees were given probation (and one was fined $350). The two private detectives were each fined $250, placed on two-year probation, and jailed for short periods of time (i.e., 24 hours for two Tuesdays).

Reasons for change

The committee decided that the present provisions designed to enforce the rules against the improper use or disclosure of returns and return information are inadequate. The committee decided that the criminal penalties for an authorized disclosure should be increased and that the situations to which they apply should be broadened to cover all situations in which returns and return information are treated as confidential. It was the opinion of the committee that in situations where an unauthorized disclosure is made to a person in exchange for an offer by that person of something of material value, that the person actively soliciting the unauthorized disclosure is at least equally responsible as the person making the disclosure and thus should be subject to the same punishment. The committee also decided that, in order to redress any injury sustained and to aid in the enforcement of the confidentiality rules, a civil action for damages should be provided to any person injured by a willful or negligent disclosure in violation of the amendment.

Explanation of provision

Under the committee amendment, a criminal violation of the disclosure rules would be a felony rather than a misdemeanor. The criminal penalties for an unauthorized disclosure of a return or return information would be increased to a fine of up to $5,000 (instead of

$1,000) and up to five years imprisonment (instead of one year), or both.

The unauthorized disclosures with respect to which the criminal penalties would apply would be expanded beyond those subject to criminal penalties under present law. The penalties would apply to any unauthorized disclosure of any return or return information; they would not, as under present law, apply solely to unauthorized disclosures of income returns and financial information appearing on income returns. As under current law, the criminal penalties would apply to unlawful disclosures by any Federal officers or employee, by any officer, employee, or agent or any State or political subdivision, or by any one-percent shareholder allowed to inspect the returns of a corporation. In addition, the criminal sanctions would apply to former Federal and State officers and to officers and employees of contractors having access to returns and return information in connection with the processing, storage, transmission, and reproduction of such returns and return information, and the programming, maintenance, etc., of equipment. The criminal penalties would also apply to any person who prints or publishes any return information which he knows was disclosed to him in violation of the law (as contrasted with present law under which the criminal penalties only apply to the unauthorized printing or publishing of income returns or certain financial information appearing thereon).

The amendment would also make it a felony, subject to the same penalties, for any person to willfully receive returns or return information as the result of a solicitation of the returns or return information. The criminal penalties would only apply if the person making the solicitation knows that the disclosure to him of the returns or return information is unlawful. For this purpose, a solicitation means an offer to exchange an item of material value in exchange for the unauthorized disclosure of the returns or return information. Thus, the criminal penalties would not apply to the receipt of returns or return information as the result of a request if the person making the request did not offer to exchange an item of material value for the disclosure, even where that person knows that the disclosure to him is in violation of the law.

The committee also decided to establish a civil remedy for any taxpayer damaged by an unlawful disclosure of returns or return information. The cause of action would extend to any disclosure of return or return information which is made in violation of section 6103. Under the amendment, any person who willfully or negligently discloses returns or return information in violation of the law would be liable to any taxpayer for actual damages sustained plus court costs. Punitive damages would also be authorized in situations where the unlawful disclosure is willful or is the result of gross negligence. Because of the difficulty in establishing in monetary terms the damages sustained by a taxpayer as the result of the invasion of his privacy caused by an unlawful disclosure of his returns or return information, the amendment provides that these damages would, in no event, be less than liquidated damages of $1,000 for each disclosure. The committee does not intend that a disclosure of returns or return information made pursuant to a good faith, but erroneous, interpretation of the confidentiality rules would constitute an actionable disclosure. Instead, disclosures which would give rise to civil liability would be limited to those situations where the unauthorized disclosure results from a willful or negligent failure of the person to comply with the procedures and safeguards provided for in this amendment and in regulations interpreting this amendment.

3. Income Tax Return Preparers (sec. 1203 of the bill and secs. 6060, 6103, 6107, 6109, 6503–6504, 6511, 6694–96, 7407–08, 7701, and 7727–28 of the Code)

Present law

The Internal Revenue Code presently contains few provisions which affect the conduct of persons who prepare the tax returns of other persons for a fee. The tax return forms generally require that any person preparing a return for another person sign the return, but the law provides no penalty in cases of failure to sign. No other provisions in the Code require that an income tax return preparer disclose to the IRS whether he is in the business of preparing returns or what returns he has prepared.

In addition, most penalties set out in the Internal Revenue Code for improperly prepared returns are penalties which relate to improper preparation by the taxpayer himself and not by a paid preparer. Taxpayers may be subject to criminal fraud penalties of up to $10,000 in fines and imprisonment for not more than five years for willful attempts to evade tax (sec. 7201). Taxpayers are also subject to civil fraud penalties of up to 50 percent of the amount of any underpayment of tax as well as penalties for negligence or intentional disregard of rules and regulations in an amount equal to 5 percent of any underpayment of tax (sec. 6653).

By contrast, persons who prepare returns of others for a fee are only subject to criminal fraud penalties for willfully aiding or assisting in the preparation of a fraudulent return. This crime can be punished by fines of up to $5,000 and imprisonment for not more than three years (sec. 7206).

Reasons for change

The past few years have seen a substantial increase in the number of persons whose business is to prepare income tax returns for individuals and families of moderate income. The Internal Revenue Service estimates that for the year 1972, 35 million taxpayers, or one-half of all those who filed income tax returns, sought some form of professional or commercial tax advice in preparing their returns. The Internal Revenue Service also estimates that in 1972 approximately 250,000 persons were engaged in the business of preparing income tax returns.

The rapid growth of the business of professional and commercial preparation of tax returns has led to a number of problems for the Internal Revenue Service. Some abuses have arisen in the preparation of returns for wage earners at the cost of a relatively small fee. In some of these cases, return preparers have made guarantees that individuals will obtain a refund because of the tax expertise of the preparer. In other cases, return preparers have suggested that a taxpayer sign a blank return (i.e., before it is prepared). Thus, the taxpayer would not look at the return or review it before it is filed. In some of these cases, the preparer either claimed fictitious deductions or increased the number of exemptions claimed in order to achieve the refund or tax liability which was promised to the taxpayer.

In 1972 and again in 1973, the IRS conducted surveys of preparers suspected of engaging in these types of conduct. For 1972, the IRS discovered that about 60 percent of the returns surveyed (or over 3,000 returns) showed significant fraud potential. In the 1973 survey which was based on a more random selection of preparers than those checked in 1972, 22.3 percent of the returns prepared by preparers (1,112 returns) showed fraud potential. The sizable number of returns with fraud potential still resulted in part because the IRS focused on preparers suspected of improper conduct. Nonetheless, the surveys indicate that a significant number of preparers in those years had engaged in abusive practices.

Under present law, it is difficult for the IRS to detect any individual case of improper preparation because the tax return preparer is not required to sign the return. Thus, the IRS has no way of knowing whether the return was prepared by the taxpayer or by a preparer who may be engaging in abusive practices involving a number of returns.

Furthermore, even if the IRS could trace the improper preparation of tax returns to an individual tax return preparer, the only sanctions available against such preparers are the criminal penalities of the tax law. Such criminal penalties are often inappropriate, cumbersome, and ineffective deterrents because of the cost and length of time involved in trying these cases in court. Because these criminal penalties are difficult to apply under present law, the IRS generally proceeds against only the most flagrantly fraudulent cases involving income tax return preparers.

At the request of the Joint Committee on Internal Revenue Taxation, the General Accounting Office conducted a study of tax return preparation by all types of tax return preparers. The GAO report indicates that commercial preparers on the average have not had a significantly greater tendency to make mistakes in preparing returns than have other types of preparers. For example, the GAO studied the 22,000 tax returns which were audited in depth for the year 1971 under the IRS Taxpayer Compliance Measurement Program. The GAO discovered that for all returns (excluding 1040A short form returns) with adjusted gross incomes o[c] $10,000 and under, and for nonbusiness returns with adjusted gross incomes between $10,000 and $50,000, the percentage of tax adjustment determined from the IRS audits averaged 10.9 percent for returns prepared by commerical preparers and 10.2 percent for returns prepared by professional preparers. Other parts of the study indicate also that commercial preparers are no more likely to make more or larger mistakes on the returns they prepare than are professional preparers. This result probably occurs because most commercial preparers are generally involved only with those returns which are relatively simple to prepare, while professional preparers are generally involved with more complex returns.

It should be noted in this regard that these errors do not necessarily result from the types of abuses described above but may result from differences of interpretation or other similar mistakes. In those cases where the IRS determines that a certain return preparer has made erroneous interpretations of the tax law, regulation of all preparers would allow the IRS to correct these errors on all the returns prepared by that preparer. The fact that all types of preparers are about equally likely to make errors in preparing tax returns has led the GAO to recommend that any regulation of tax return preparers apply equally to all preparers.

To aid the Internal Revenue Service in detecting incorrect returns prepared by tax return preparers, and to deter preparers from engaging in improper conduct, the committee amendment includes a number of provisions requiring tax return preparers to disclose to the IRS certain information and subjecting preparers to penalties for failure to comply with the information requirements and for improper preparer conduct.

Explanation of provision

The committee amendment provides disclosure requirements and standards of conduct which are applicable to income tax return preparers. It gives the Secretary of the Treasury the power to impose penalties or to seek injunctions against preparers because of certain specified prohibited practices. The amendment is substantially the same as the provisions in the House bill with several modifications, as indicated below.

Definition of income tax preparer.—The committee amendment applies to any person who is a tax return preparer, regardless of the educational qualifications or professional status of the person. An income tax return preparer means any person who prepares, for compensation, all or a substantial portion of a tax return or claim for refund. Whether or not a portion of a return constitutes a substantial portion is to be determined by examining both the length and complexity of that particular portion of the return and the amount of tax liability involved. Generally, the filling out of a single schedule of a tax return would not be considered a substantial portion of that return unless that particular schedule was the dominant portion of the entire tax return.

A person who prepares a return for compensation may be an income tax return preparer even though that person does not actually place the figures on the lines of the taxpayer's final tax return. A person who supplies to a taxpayer sufficient information and advice so that filling out the final tax return becomes merely a mechanical or clerical matter is to be considered an income tax return preparer. However, an individual who gives advice on particular issues of law or IRS policy relating to particular deductions or items of income will not have prepared a return with respect to those issues if the advice does directly relate to any specific amounts which are to be placed on the return of the taxpayer.

The definition of income tax return preparer includes only persons who prepare the returns of others for compensation. A person who fills out a return gratuitously for a friend or a relative, for example, will not be considered an income tax return preparer. In addition, a person who fills out a return for a friend or neighbor with no explicit or implicit agreement for compensation will not be considered to have prepared the return for compensation even though that person receives an expression of gratitude (such as an invitation to dinner or a returned favor from the taxpayer).

The term "income tax return preparer" includes the employer of persons who prepare the returns of others for compensation as well as the persons actually preparing returns.[1] In cases where more than one person aids in filling out a single return under one employer, the individual who has the primary responsibility for the preparation of the entire return or of a substantial portion of the return will usually be an income tax preparer, while those persons involved only with individual portions of the return will usually not be income tax return preparers. The fact that a person who prepares an entire return or a substantial portion of the return has his work reviewed by a more senior employee does not by itself mean that the person preparing the return is not an income tax return preparer.

The amendment provides four specific exceptions to the definition of an income tax return preparer. First, a person is not considered a preparer merely because that person furnishes typing, reproducing or other mechanical assistance in preparing the return. Thus, a person who provides a computerized service for filling out returns from information supplied by the taxpayer or advisors of the taxpayer is not considered an income tax return preparer if the processing done by such person is limited to mechanical calculations and processing. Second, an employee is not a tax return preparer merely because he prepares the return or a claim for refund for his employer or for employees of the employer. However, such individual must be a regular and continuous employee of the employer and not an independent contractor. For example, an individual who maintains his own accounting practice, but who every year, at the appropriate time for filing returns, is hired by an employer to prepare that employer's returns or the individual returns of officers or employees of that employer, is considered an income tax return preparer. Third, the amendment provides that a person is not an income tax return preparer merely because he prepares a return or a claim for refund for any trust or estate of which that person is a fiduciary. Fourth, under the committee amendment, a person will not be considered a tax return preparer merely because he prepares a refund claim which is filed as a result of an Internal Revenue Service audit. The fourth exception includes preparers of refund claims in three specific types of situations. The first situation arises when a taxpayer's income tax return for a year has been audited, a deficiency assessed and collected, or a notice of deficiency issued, or a waiver of restrictions on assessment and collection issued after the commencement of the audit, and the taxpayer elects to challenge the Service's determination of his liability for that tax year by filing a claim for refund in order to perfect his right to a judicial resolution of the controversy. The second situation arises

[1] A person who retains one or more persons to prepare the income tax returns of others is an income tax return preparer whether or not the persons retained are technically considered employees or agents. The fact that the persons retained are not considered employees for purposes of other federal laws does not mean that, for purposes of this provision, the person retaining the income tax preparers is not also to be treated as an income tax preparer.

where determinations made in the course of an audit of a taxpayer for one tax year can affect his liability in another year. The preparation of a claim for refund for the affected year will not by itself cause the preparer of the refund claim to be an income tax return preparer under this provision of the committee amendment. Similarly, in the third case, merely preparing a refund claim for a taxpayer whose tax liability has been affected directly or indirectly by a determination made in the audit of another taxpayer does not render the person preparing the claim for refund an income tax return preparer under this provision.

The definition of a tax return preparer relates only to returns of taxes imposed by subtitle A of the Internal Revenue Code and to claims for refund of taxes imposed by subtitle A.

The committee amendment is the same as the House bill in defining an income tax return preparer except in the case of certain refund claims.

Disclosure requirements.—The committee amendment requires that any person preparing an income tax return state on that return his identification number, the identification number of his employer, or both, in the manner presecribed by the Secretary. In cases of returns prepared by more than one return preparer, the Secretary may also establish rules determining which preparer or preparers are required to place their identification number on the return. The amendment establishes a $25 penalty for each failure to furnish a proper identification number on a return unless a failure is due to reasonable cause and not due to willful neglect. In conjunction with this identification requirement, a failure by a return preparer to sign any return if required to do so under regulations prescribed by the Secretary, will result in a $25 penalty. However, the amendment does not change present law with respect to the Secretary's authority to require that the name of any income tax return preparer appear on any return.

The amendment also requires that any income tax return preparer retain a copy of all returns prepared by him, or alternatively retain a list of all taxpayers and their identification numbers for whom returns were prepared. The copies of the return or the list of returns prepared are to be kept by the preparer for three years. This provision, in addition to the requirement that the preparer place his identification number on the return itself, is to enable the IRS to identify all returns prepared by a specific individual in cases where the IRS has discovered some returns improperly prepared by that individual. The amendment provides for a $50 penalty for each failure to keep a return or to include a return on a list of prepared returns. The maximum penalty under this provision is $25,000 with respect to any person for any return period. This penalty applies unless the failure is due to reasonable cause and not to willful neglect.

The committee amendment also requires that employers of income tax return preparers make an annual report to the IRS listing the name, taxpayer identification number, and place of work of each tax return preparer employed during the year. For purposes of this requirement, an individual who is self-employed as an income tax return preparer, or who acts as an independent contractor (other than as an agent of another tax return preparer who files an information return which includes the agent), is required to file his own information report. The IRS may provide regulations permitting a parent corporation to file a single consolidated annual report for all o. its subsidiaries and franchises. The committee amendment is the same as the House bill with respect to this provision except that if it is determined that the information generally required on an annual report is available to the Service from sources other than such a report, the Secretary may approve alternative compliance methods including, for example, guarantees of access to records which provide the information required by the Secretary without filing a report, or permitting a summary-type report, provided the employer keeps more detailed records available and accessible to the Service.

Failure of an employer to file an annual report or to comply with alternative compliance procedures will result in a penalty of $100 for each report which is not filed or is not made available to the Service, plus $5 for each omitted item which should have been included on any report or made available to the Service. Thus, an individual who files an incomplete report will incur a penalty of $5 for each item improperly excluded; an individual who files no report will be assessed $100 plus $5 for each item which would have been included on a properly-filed report. The maximum penalty under this provision is $20,000 with respect to any person for any report period.

The amendment also requires that a tax return preparer furnish a completed copy of any return prepared by him to the taxpayer either prior to or at the same time as the return is presented to the taxpayer for his signature. The purpose of this provision is to insure that the taxpayer receives a copy of the completed return to review its accuracy, and to insure that the final return is not signed by the taxpayer prior to its completion. A tax return preparer who fails to provide a completed copy of the return to the taxpayer at the appropriate time is subject to a penalty of $25 for each such failure unless due to reasonable cause and not to willful neglect.

The amendment also requires that in the case of an individual, the taxpaver identification number required on any return is to be the individual's social security account number. This provision applies both to tax return preparers and to individual taxpayers. The employer identification number is required in the case of estate tax returns.

The House bill permits States or local governing bodies charged with the administration of any tax law in their jurisdiction to obtain the social security account number or employer identification number assigned to any taxpayer upon application to the Secretary for use in fulfilling their tax administration responsibilities. The committee amendment deletes this part of the provision of the House bill but provides a separate and broader provision which encompasses the House version and which is described later in this report.

Finallv, the amendment permits the IRS to give to State or local governing bodies charged with licensing, registering or regulating income tax preparers information contained on the annual information reports submitted to the Internal Revenue Service which identifies tax return preparers or which indicates anv penalties which have been assessed. However, such information may be furnished onlv upon written reauest by the Governor or Chief Executive Officer of the State in which the governing body is located. The request must designate the body to which such information is to be furnished. The information furnished may be used by the State or local governing body only for the purposes of licensing, registering or regulating income tax return preparers. State employees who make an unauthorized disclosure of any information furnished by the IRS may be subject to misdemeanor penalties of imprisonment for up to one year and penalties of up to $1,000 (sec. 7213(b)).

Penalties for negligent or fraudulent preparation.—In addition to the penalties provided for failure to comply with the disclosure and information return requirements, the committee amendment establishes new penalties for certain negligent or willfull attempts to understate a taxpayer's tax liability. These penalties are primarily aimed at deterring income tax return preparers who prepare a large number of returns from engaging in negligent or fraudulent practices designed to understate a taxpayer's liability.

The committee amendment establishes a penalty of $100 for each return on which an understatement of tax liability is caused by negligent or intentional disregard of the Federal tax law or rulings and regulations by an income return preparer. The rules and regulations to which this provision applies include the Treasury regulations and IRS rulings. The penalty applies generally to every negligent or intentional disregard of such regulations and rulings except that a good faith dispute by an income tax return preparer about an interpretation of a statute (expressed in regulations or rulings) is not considered a negligent or intentional disregard of rulings and regulations. The provision is thus to be interpreted in a manner similar to the interpretation given the provision under present law (sec. 6653(a)) relating to the disregard of rules and regulations by taxpayers on their own returns. If an income tax return preparer believes in good faith that case law conflicting with rulings or regulations, more accurately interprets one or more sections of the Internal Revenue Code, he may complete a return on the basis of such case law, provided he clearly sets forth in the return the relevant rulings or regulations which he disputes and the judicial decision upon which he relies.

The negligence penalty applies to the specific income tax return preparer who negligently or intentionally disregards rules or regulations. The penalty is not to be imputed to an employer of a tax return preparer solely by reason of the employment relationship; the employer or one or more of its chief officers also must have negligently or intentionally disregarded the rules or regulations if the employer is to be penalized. For example, if an employer or another employee supervises the preparation of a return by an income tax preparer, any negligent or intentional disregard of rules and regulations which occurs in connection with that return may be attributable to the person supervising the preparation of the return if that person had responsibility for determining whether or not the rules and regulations were followed, or if that person in fact knew that the rules or regulations were not followed.

The amendment provides a second penalty of $500 for each return on which any understatement of liability results from a willful attempt to understate tax liability by a tax return preparer. A willful understatement of tax liability includes situations where an income tax return preparer disregards facts supplied to him by the taxpayer (or others) in an attempt to reduce the taxpayer's liability. For example, if a taxpayer states to the return preparer that he has only two dependents, and the preparer, with full knowledge of that statement, reports six dependents on the tax return, a willful attempt to understate tax liability has occurred. A willful attempt also occurs generally where an income tax return preparer disregards certain items of income given to him by the taxpayer or other persons. While the three-year statute of limitations is to apply to the assessment of the penalty for negligent or intentional disregard of rules and regulations, no statute of limitations is to apply to the willful understatement penalty.

A willful understatement of tax liability can also include an intentional disregard of rules and regulations. For example, an income tax return preparer who deducts all of a taxpayer's medical expenses, intentionally disregarding the percent of adjusted gross income limitation, may have both intentionally disregarded rules and regulations and willfully understated tax liability. In such a case, the Internal Revenue Service can assess either or both penalties against the income tax return preparer. However, the total amount collected by reason of imposing both penalties cannot exceed $500 per return. Thus, the IRS could in this and in other cases first assess the negligent or intentional disregard of rules and regulations penalty, and then at a later date, assess the penalty for the willful understatement of tax liability. But if the first penalty of $100 is collected, the later assessment for willful understatement of tax liability would be limited $400 per tax return.

The negligence and willful understatement penalties apply only to cases where there is an understatement of tax liability. An understatement of tax liability occurs when any net amount payable with respect to any tax imposed by subtitle A of the Internal Revenue Code is understated or when any net amount of such tax which is refundable or creditable against future taxes is overstated. No final administrative or judicial determination with respect to any taxpayer is required as a condition of an understatement of tax liability. An understatement of tax can exist if it is shown in fact to exist in the proceeding against the return preparer regardless of what actions, if any, the Internal Revenue Service has taken against the taxpayer involved.

Both the negligent or intentional disregard of rules and regulations penalty and the willful understatement of liability penalty are to be assessed independently of any taxpayer deficiencies asserted against the income tax return preparer (and the other assessable penalties which have been discussed in connection with the disclosure requirements). Under normal IRS procedures, an investigation would be made before the assessment. A revenue agent's report would be filed, followed by a thirty-day letter to the income tax preparer notifying him of the proposed penalty and giving him an opportunity to pursue administrative remedies prior to the assessment of the penalty. After these appeals are exhausted, if the IRS assesses the penalty, it must make a statement of notice and demand (separate from any taxpayer notice of deficiency) to the income tax return preparer. The penalty is payable upon assessment.

An income tax return preparer can appeal the assessment of the penalty by paying the amount assessed and filing a claim for a refund.[2] If the refund claim is denied by the Internal Revenue Service, the income tax return preparer can appeal that denial to the courts.

In addition to this refund procedure, the amendment provides that an income tax return preparer can appeal an assessment of the penalty if he pays 15 percent of any penalty within thirty days of the notice of assessment and files a claim for a refund at that time. During the period when the claim for refund or appeal of any refusal to refund is pending, the Internal Revenue Service may not proceed to collect any part of the remaining 85 percent of the penalty. However, with respect to any penalty for which the 15 percent amount is not paid, the Internal Revenue Service is free to pursue collection.

If the Internal Revenue Service denies a claim for refund of the 15 percent of the penalty assessed, the income tax return preparer may appeal the matter to the appropriate U.S. district court within thirty days and avoid any further IRS collection of the remaining 85 percent of the penalty. If the IRS does not rule on a claim for refund by the end of six months after the time the claim is presented, the preparer can sue in court within thirty days after the end of the six-month period. In such a suit, the Internal Revenue Service need not file a counterclaim for the remaining 85 percent of outstanding penalties because any court decision with regard to the refund of 15 percent of the penalty will apply equally to the remaining 85 percent. If the preparer does not begin a suit within the thirty-day period, the IRS can proceed with collection of the remaining 85 percent of the penalties.

In any trial on the merits of assessed penalties, the IRS bears the burden of proof if the penalty assessed is for willful understatement of tax liability. If the penalty is for intentional or negligent disregard of Internal Revenue Code rules or regulations, the preparer bears the burden of proof. However, if a preparer can show that his normal practice with respect to the treatment of a particular income or deduction item was not negligent and if there is evidence that normal practice was followed, the preparer will be considered to have met his burden of proof unless the Service presents contrary evidence. For example, if a tax return preparer prepared returns for 10 years based on a revenue ruling which the Service revoked during the fifth year, the preparer would be considered negligent at least with regard to returns prepared in accord with the ruling for the sixth, seventh, eighth, ninth and tenth years, and (depending upon the facts and circumstances) perhaps also for the fifth year.

In the case of any claim for refund based on the 15 percent payment, the IRS may resume its collection activities only upon final resolution of the matter. Final resolution includes any settlement between the Internal Revenue Service and the income tax return preparer, or any final decision by a court, and includes the types of determinations provided under existing law (sec. 1313(a)) relating to taxpayer deficiencies. During any period of appeal of any assessed penalty for which the IRS is prevented from pursuing collection of

[2] If the income tax return preparer pays the entire amount of the penalty, a claim for refund can be filed at any time within three years after the time the penalty was paid.

the remainder of the penalty, the running of the statute of limitations for collection is suspended.

Regardless of whether or not the penalties assessed are appealed by the income tax preparer, any payment of such penalties will be refunded to the income tax return preparer if it is determined by final administrative or judicial action involving the taxpayer that there was no understatement of liability in the case of the return for which the penalty was assessed. For example, if an income tax return preparer pays the penalty with respect to a specific return and at a later date the taxpayer obtains an administrative or judicial determination to the effect that no understatement of tax existed on his return, a refund of the penalty is to be automatically provided to the income tax return preparer. The Internal Revenue Service is to make this refund to the income tax return preparer whether or not a request for the refund is made by the preparer and regardless of the running of any statute of limitations.

In addition, the amendment establishes a civil penalty of $500 against any income tax return preparer who endorses or otherwise negotiates (directly or through an agent) any check which is issued with respect to taxes imposed by subtitle A of the Internal Revenue Code and which is issued to a taxpayer other than the income tax return preparer. This provision is to apply to endorsements (such as forgeries) or other negotiations which are illegal under present law as well as to presently legal transactions where a return preparer endorses or negotiates a check issued to another taxpayer (for example, by reason of a power of attorney or because of a specific or bearer endorsement by the taxpayer). This penalty is to apply whether or not the return preparer endorses or negotiates the check directly or through some other person (other than the taxayer) as agent on his behalf.

Power to seek injunctions.—The committee amendment grants the Secretary the power to seek an injunction prohibiting an income tax return preparer from engaging in specific practices or from acting as an income tax return preparer. The Secretary may bring suit in the United States District Court for the district in which the preparer resides, or has his principal place of business, or the district in which the taxpayer whose return is the basis for the action resides.

The injunction may be sought whenever the Secretary believes that an income tax return preparer has engaged in conduct subject to monetary penalties under the provisions of the committee amendment, has engaged in conduct subject to criminal penalties under the Internal Revenue Code, has misrepresented his eligibility to practice before the Internal Revenue Service, has misrepresented his experience and education as an income tax return preparer, has guaranteed the payment of any tax refund or the allowance of any tax credit, or has engaged in any other fraudulent or deceptive conduct similar in nature to the above types of conduct which substantially interferes with the proper administration of the internal revenue laws. If the court believes injunctive relief is appropriate, it may enjoin an income tax return preparer from continuing to engage in such conduct. If the court determines that a preparer has continually or repeatedly engaged in any such conduct and that an injunction prohibiting only the specific type of conduct would not suffice to prevent interference with tax administration, the court may enjoin the preparer from engaging in business as a tax return preparer.

The Secretary may seek such an injunction without regard to whether or not penalties have been or may be assessed against any income tax return preparer. Thus, it would be permissible for the Secretary both to assess penalties against a taxpayer for certain acts and to seek an injunction prohibiting the tax return preparer from engaging further in such conduct or from acting as an income tax return preparer.

The injunctive relief sought by the Secretary must be commensurate with the conduct which led to the seeking of the injunction. For example, if an income tax return preparer, who is only experienced in preparing individuals' returns, overstates his qualifications as a preparer by claiming expertise in the preparation of corporate returns, it is anticipated that any injunction would be directed toward the misrepresentation itself or the preparation of corporate returns and not toward preventing the preparer from preparing any returns at all. Furthermore, if some of an employer's employee-preparers have engaged in conduct leading to a request for an injunction against the further preparation of returns, any injunction is to be sought only against those preparers and not the employer (or other employees), unless the employer (or other employees) is actively involved in the improper conduct. Nothing in this provision is to alter the inherent authority of the courts to limit the scope and duration of any injunction as is deemed appropriate given the actions leading to the request for injunctive relief.

To the extent permitted under the Federal Rules of Civil Procedure, the Secretary may seek a temporary restraining order on an *ex parte* basis under this provision. However, the Secretary is to seek such an order only in those extreme cases where the administration of the tax laws would be irreparably harmed by the continuation of the conduct against which the restraining order is sought.

An income tax return preparer may, however, prevent the Secretary from initiating or pursuing an injunctive action based on the penalties provided for in this bill if such preparer files with the Secretary a bond of $50,000 as surety for the payment of any of the penalties which might be assessed. The bond need not be continued if the penalties which gave rise to the injunctive action have been assessed and paid.

Effective date

This provision is to apply to documents prepared after December 31, 1976.

Revenue estimate

This provision will not have any revenue impact.

4. Jeopardy and Termination Assessments (sec. 1204 of the bill and secs. 6851, 6863, and 7429 of the Code)

Present law

Under normal assessment procedure, there is generally a considerable lapse of time between a taxpayer's first notice that the Internal Revenue Service is seeking to collect taxes from him and the actual enforced collection of those taxes. For example, a taxpayer who does not agree with a proposed assessment of income taxes may pursue administrative appeals within the Service, and, if no agreement is reached, the taxpayer may petition the Tax Court after the Service has issued a notice of deficiency, all without paying the tax allegedly due. On the other hand, when the Service determines that the collection of a tax may be in jeopardy, it may forgo the normal time-consuming assessment and collection procedures and immediately assess and collect the tax. For this purpose, there are two basic types of special assessments—jeopardy assessments and termination assessments.[1]

Jeopardy assessments are of two different types depending on whether the taxes involved are (1) income, estate, gift, or certain excise taxes (those taxes that are normally dealt with under the notice of deficiency procedures) or (2) other taxes (such as employment taxes and wagering taxes).

Use of jeopardy assessments related to income, etc., taxes.—If the Service determines that the collection of income estate, gift, or certain excise taxes is in jeopardy, a jeopardy assessment may be made under section 6861 of the Code. Under such an assessment, the Service determines that a deficiency exists and that its assessment or collection would be jeopardized by the delay. The Service is then authorized immediately to (1) assess the tax, (2) send a notice and demand for payment, and (3) levy upon the taxpayer's property for its collection. The 10-day waiting period normally required between demand for payment and seizure of the taxpayer's property does not apply in this case. However, if the jeopardy assessment is made before the statutory notice of deficiency is sent to the taxpayer, the Service is required to send the notice within 60 days after the jeopardy assessment is made.

The judicial remedies available to a taxpayer who has been subject to a section 6861 jeopardy assessment are identical to the remedies available for a normal assessment. Upon receiving a notice of deficiency, the taxpayer may file a petition for redetermination in the Tax Court.[2] Alternatively, the taxpayer may pay the full amount of the deficiency, file a claim for refund with the Service, wait 6 months (unless the claim is denied by the Service sooner), and then file a refund action in a Federal district court or the Court of Claims.

The taxpayer who has been subjected to a jeopardy assessment, however, does not have all the protection afforded the ordinary taxpayer during the judicial review. In the normal deficiency case, the Service is prohibited from making an assessment and taking collection action against a taxpayer's property prior to the time allowed for filing a petition for redetermination and during the time litigation is pending in the Tax Court. Although the Service is generally precluded from selling any property seized prior to or during Tax Court litigation, the jeopardy taxpayer—unlike the ordinary taxpayer—loses the

[1] The Internal Revenue Manual states that a jeopardy or termination assessment should not be made unless at least one of the following three conditions is met:

(1) The taxpayer is or appears to be designing quickly to depart from the United States or to conceal himself;

(2) The taxpayer is or appears to be designing quickly to place his property beyond the reach of the Government either by removing it from the United States, or by concealing it. or by transferring it to other persons. or by dissipating it; or

(3) The taxpayer's financial solvency appears to be imperiled.

[2] The notice is a jurisdictional prerequisite to litigation in the Tax Court.

use of whatever property has been seized by the Service while relief is sought in the Tax Court.

Use of jeopardy assessments relating to other taxes.—If the Service determines that collection of any tax liability relating to a tax other than an income, estate, gift, or certain excise tax is in jeopardy, the Service may make a jeopardy assessment under section 6862. This type of jeopardy assessment differs from that jeopardy assessment under section 6861 in that the taxpayer does not have the right to appeal the Service's determination to the Tax Court because the Tax Court has no jurisdiction in cases involving the types of taxes covered by section 6862.

As in the case of a section 6861 jeopardy assessment, if the Service determines that a tax is due and that the assessment or collection of the tax would be jeopardized by delay, the Service is authorized to immediately assess and levy upon the taxpayer's property. However, unlike the prohibition that prevents the Service from selling any property seized under a section 6861 jeopardy assessment before Tax Court appeal rights have been exhausted, property seized as a result of a section 6862 jeopardy assessment (since the case cannot be taken to the Tax Court) can be sold before the taxpayer has a right to contest the tax liability.

The appeal rights for a taxpayer who has been subject to a section 6862 jeopardy assessment begin after payment of the tax and filing of a claim for refund with the Service. The taxpayer must wait 6 months—unless the Service denies the claim sooner—and then either the Federal district court or Court of Claims will consider a refund suit by the taxpayer.

Use of termination assessments.—The two types of jeopardy assessment discussed up to this point are used only where the deficiency is determined after the end of the year to which it relates. A termination assessment (sec. 6851 of the Code) may be made when the collection of an income tax is in jeopardy before the end of a taxpayer's normal tax year or before the statutory date the taxpayer is required to file a return and pay the tax. Under a termination assessment, which may be made only to collect income taxes, if the Service finds that the collection of a tax is in jeopardy, it is authorized to:

(1) serve notice on the taxpayer of the termination of his taxable period;

(2) demand immediate payment of any tax determined to be due for the terminated period; and

(3) if payment is not received, immediately levy upon the taxpayer's property.

Any amount collected as a result of the termination assessment is credited against the tax finally determined to be due for the taxpayer's full year liability. The 10-day waiting period normally required between demand for payment and seizure of the taxpayer's property does not apply when a termination assessment is made.

In recent years there has been considerable litigation and confusion concerning the judicial remedies of taxpayers who have been subject to termination assessments. It has been the Service's position, in the case of termination assessments, that its authority to assess is *not* limited by requirements (such as found in section 6861) that the Service must send to the taxpayer a deficiency notice within 60 days after assessment. Thus, under the Service's position, a taxpayer who has been subject to a termination assessment may contest the assessment only by (1) paying the assessed tax, (2) filing a claim for refund with the Service, and (3) after 6 months, unless the refund claim is denied sooner, filing a refund action with the Federal district court or Court of Claims. Since it also has been the Service's practice not to consider a refund claim until after the end of the taxpayer's normal tax year, there could be a considerable delay until the taxpayer can obtain judicial review of his case, and during this delay the taxpayer is deprived of the use of any refund to which he would be entitled. Before the *Laing* decision (see footnote 3, below), some courts had sustained the Service's position, and other courts had rejected it.

On January 13, 1976 (after H.R. 10612 was passed by the House), the Supreme Court held[3] that when a taxpayer has been subjected to a termination assessment, the Service is required to send the taxpayer a notice of deficiency within 60 days after assessment (see footnote 2, above). In addition, the Court held that the Service has no authority to sell property seized pursuant to a termination assessment before the taxpayer has had an opportunity for judicial review of the tax liability in the Tax Court.

In recent years, most taxpayers who have been subject to termination assessments have been suspected of dealing in narcotics. Particularly during 1972 and 1973, a concerted effort was made to utilize termination assessments to "reduce the profitability" of dealing in illegal drugs. In 1974, however, the Service revised its guidelines to emphasize that termination assessments (and jeopardy assessments) were to be utilized to achieve maximum compliance with the internal revenue laws rather than to attempt to disrupt the distribution of narcotics.

Reasons for change

As a result of concern in this area, the Joint Committee on Internal Revenue Taxation, on December 27, 1974, requested the General Accounting Office to act as its agent in reviewing the procedures followed by the Internal Revenue Service in making jeopardy assessments. The review was to include how the Service uses these enforcement tools, how often they are used, and whether their use varies significantly from district to district. Because of developing Congressional tax reform schedules, the GAO expedited its review and therefore limited its work to two IRS districts. The GAO has recently submitted its report to the Joint Committee.

The GAO report indicated that most jeopardy assessments and termination assessments were utilized against taxpayers allegedly engaged in illegal activities, although some of the jeopardy assessments under section 6862 were utilized to collect penalty taxes from persons who had failed to collect, or pay over, employment taxes. Although the GAO generally concluded that these types of assessments had not been misused, it did note that the termination assessments were generally unproductive from a tax collection viewpoint,

[3] *Laing* v. *United States*, —— U.S. ——, 76–1, USTC par. 9164, 37 AFTR 2d 76–530. 96 S. Ct. 473.

since in 25 cases which had been completed at the time of review, $742,294 was assessed but the total tax deficiency after audit was only $36,665 (4.9 percent of the assessments). The GAO also noted that, in at least one case where a section 6862 jeopardy assessment was used to collect penalty taxes resulting from a corporation's failure to pay employment taxes, it was at least possible that the taxpayer was not liable for payment of the penalty tax.

The jeopardy and termination assessment powers granted to the Internal Revenue Service are generally considered valuable weapons which the Service can effectively utilize iin unusual circumstances to prevent taxpayers from avoiding the payment of taxes. However, a taxpayer who has been subjected to such an assessment may suffer considerable hardship. This may result from the suddenness with which action may be taken.

Hardship may also result because of the requirement that, if the assessment is made under section 6862 (jeopardy assessment for other than income, estate, or gift tax, or certain excise taxes), the taxpayer must pay the tax, file a claim for refund, and then wait six months before filing a suit for refund. In addition, property seized following a jeopardy assessment under section 6862 can be sold before the taxpayer can contest the tax liability.

Since a taxpayer subjected to a section 6851 termination assessment or a section 6861 jeopardy assessment must be mailed a deficiency notice within 60 days after the assessment, the problem is less acute in this case than in the case of a taxpayer subjected to a section 6862 assessment. However, since, even in the case of a termination assessment or a section 6861 jeopardy assessment, a taxpayer may have to wait at least 60 days to petition the Tax Court and then his case will be placed on the regular docket of the Tax Court, his judicial remedy (considered in the light of the fact that substantially all of his assets may have been seized) is not sufficiently speedy to avoid undue hardship in cases where the assessment may have been inappropriate. In addition, although a taxpayer subjected to an assessment under section 6851 or 6861 has statutory protection against his assets (seized pursuant to the assessment) being sold prior to or during judicial proceedings, no such protection exists with respect to assets seized pursuant to assessments made under section 6862.

Furthermore, some may argue that under present law a taxpayer's rights for review of the Service's action are constitutionally inadequate. That argument would be based on the premise that, in view of the hardship that may be suffered by a taxpayer who has been the subject of a jeopardy or termination assessment, it is not sufficient to provide that within 60 days a taxpayer could file a petition with the Tax Court which generally could be expected to render an opinion within 12 to 30 months after the petition is filed.

On March 8, 1976, the Supreme Court decided the case of *Commissioner* v. *Shapiro*, —— U.S. ——, 76–1 USTC par. 9266, 37 AFTR 2d 76–959 (1976), involving an interpretation of the Anti-Injunction Act (section 7421 of the Code) with respect to a taxpayer against whom a jeopardy assessment had been made. In this case, the Supreme Court rejected the Commissioner's position that he "has no obligation to provide that the seizure has any basis in fact no matter how severe or irreparable the injury to the taxpayer and no matter how inadequate his eventual remedy in the Tax Court." (Slip opinion, p. 15) The Supreme Court also indicated that, at least in certain circumstances, a taxpayer may be constitutionally entitled to a more rapid judicial or administrative review of the Service's basis for a seizure of assets pursuant to a jeopardy assessment than is provided by his right to petition the Tax Court under the normal Tax Court procedures. In its opinion (at footnote 12), the Supreme Court also stated:

"Nothing we hold today, of course, would prevent the Government from providing an administrative or other forum outside the Art. III judicial system for whatever preliminary inquiry is to be made as the basis for a jeopardy assessment and levy."

Under the circumstances, the committee feels that a taxpayer should be able to obtain judicial review of the propriety of a jeopardy assessment or a termination assessment on an expedited basis and also that assets levied on by reason of any jeopardy assessment or termination assessment should not be sold prior to or during the pendency of this judicial review. Also, the committee believes that the rules relating to the possible creation of multiple short taxable years by reason of termination assessments need to be revised.

Explanation of provisions

The committee amendment adds a new provision (sec. 7429) which provides for expedited administrative and judicial review of jeopardy and termination assessments. Under this new procedure, within five days after the date on which a jeopardy or termination assessment is made, the Service is required to give the taxpayer a written statement of the information upon which the Service relies in making the assessment. Within 30 days after the statement is furnished (or required to be furnished), the taxpayer may request the Service to review the propriety of the jeopardy or termination assessment. After such a request is made, the Service is to determine (1) whether the making of the jeopardy or termination assessment is reasonable under the circumstances and (2) whether the amount assessed is appropriate under the circumstances. In making these determinations, the Service is to take into account not only information available at the time the assessment is made but also information which subsequently becomes available.[4] If the Service finds that the assessment is inappropriate or excessive in amount, it may abate the assessment in whole or in part.[5]

If the taxpayer is not satisfied with the results of the administrative review, he may, within 30 days after the Service makes a detereminantion on his request (or, if earlier, within 30 days after the 16th day after the request for administrative review was made), bring an action in the United States District Court for the district in which he resides. Within 20 days after the commencement of this action, the district court is to make independent, de novo determinations as to (1) whether the making of the jeopardy or termination assessment is reasonable

[4] Since the Service (and the court) may rely on information which becomes available after the making of the assessment, the abatement (in whole or in part) of a jeopardy or termination assessment does not necessarily imply that the Service acted improperly in making the assessment.

[5] Both the Service and the court are intended to have discretion to abate an assessment (in whole or in part) even if the assessment is not found to be inappropriate or excessive, if there is a finding that the taxpayer would suffer unusual hardship.

under the circumstances, and (2) whether the amount assessed or demanded is appropriate under the circumstances. In making these determinations, the court is to take into account not only information available to the Service at the time of the assessment but also any other information which bears on these issues. The court has authority to effectuate its determination by ordering, where appropriate, the abatement of the assessment (in whole or in part) or other appropriate relief. The 20-day period may be extended by not more than 40 additional days at the request of the taxpayer, but may not be extended at the request of the Treasury Department or the court. It is further provided that a determination by the district court may not be appealed to or reviewed by any other court.

In this court proceeding, the Treasury Department has the burden of proof as to whether the making of the jeopardy or termination assessment is reasonable.[6] If an issue is raised as to the reasonableness of the amount assessed, the Treasury Department is required to provide a written statement (such as in its answer to the taxpayer's petition) setting forth its basis for determining the amount assessed, but the taxpayer is required to bear the burden of proof. This is similar to the division of burden of proof in civil fraud cases. The burden of proof as to the reasonableness of the assessment is placed on the Treasury Department because the making of a jeopardy or termination assessment involves more severe consequences to the taxpayer than a normal assessment, and, as in the case of civil fraud, the imposition of these consequences differs substantially from normal assessment and collection procedure.

In determining whether the amount assessed is appropriate under the circumstances, the court is not expected to attempt to determine ultimate tax liability. Rather, the issue to be determined is whether, based on the information then available, the amount of the assessment is reasonable. Thus, for example, in the absence of other evidence made available to the Internal Revenue Service before the proceeding or during the proceeding, an estimate of the taxpayer's liability to date based on information in fact available to the Internal Revenue Service will be presumed to be reasonable.

A determination made under new section 7429 will have no effect upon the determination of the correct tax liability in a subsequent proceeding. The proceeding under the new provision is to be a separate proceeding which is unrelated, substantively and procedurally, to any subsequent proceeding to determine the correct tax liability, either by action for refund in a Federal district court or the Court of Claims or by a proceeding in the Tax Court.

The House bill did not contain the requirements that the Service give the taxpayer a written statement of the information upon which it relied in making the jeopardy or termination assessment, nor did it contain any provision for administrative review. The committee amendment adds these provisions because it believes that this statement to the taxpayer and an opportunity for administrative review

[6] The committee believes that the general standards set forth in the Internal Revenue Manual relating to the conditions which must exist before a jeopardy or termination assessment is made are reasonable. (See footnote 1 for the standards provided in the manual.)

will allow the taxpayer and the Service to exchange information and, in most cases, either to work out a solution satisfactory to both parties or at least to facilitate the court proceeding. These provisions could delay court review for only 20 days, and, in the committee's judgment, the delay appears to be more than counterbalanced by the likelihood that the court proceedings would be facilitated by the exchange of information and that some court proceedings could be avoided entirely.

The House bill provided for expedited review of jeopardy and termination assessments by the Tax Court. The committee amendment provides that such review is to take place in the district court because it is contemplated that taxpayers would find it easier and more convenient to bring an action in the district courts. In addition, since the Tax Court does not have permanent facilities (or judges or commissioners sitting) throughout the country, review of these procedures is likely to be less of a burden if placed in the district courts.

The committee amendment also provides that, during the period necessary to complete administrative review, and, if administrative review is sought, during the period necessary to seek judicial review, property seized pursuant to a jeopardy or termination assessment may not be sold unless (1) it is perishable, (2) the taxpayer consents, or the expenses of conservation or maintenance would greatly reduce the net proceeds. Where judicial review is sought, these restrictions also apply during the period until a judicial determination is made. This provision is similar to the provision in the House bill.

After the House bill was passed, the Supreme Court in the *Laing* case held that, since restraints on section 6861 also applied to assessments under 6851, property seized pursuant to a termination assessment could not be sold prior to an opportunity for Tax Court review of the amount of tax liability, and if a petition is filed in the Tax Court, prior to the completion of the action on the tax liability. The committee amendment follows this decision in this respect.

Since the committee amendment provides this special proceeding whereby the taxpayer can have both administrative and judicial review of the appropriateness of the jeopardy or termination assessment within as few as 40 days after the making of such assessment, the committee believes it is appropriate to provide that the making of a termination assessment does not terminate a taxable year, create a deficiency, or require the Service to give the taxpayer a notice of deficiency within 60 days of a termination assessment. (The House bill continued present law in this regard to allow the termination of the taxable year.) The decision in the *Laing* case interprets the existing law to require such a notice within 60 days of the making of the termination assessment since it regards the amount assessed pursuant to such an assessment as a deficiency. This approach, however, would have the effect of requiring courts to make a determination of tax liability based upon less than a full taxable year. Such a determination appears to be inconsistent with the provisions of section 6851(b) allowing the taxable year to be reopened after termination until its normal end if the taxpayer has income after the termination. The requirement of multiple short taxable years could not only create administrative problems for the Service, but also could result in detriment to the taxpayer whose income tax liability might be greater because of the multiple years.[7]

Therefore, the committee amendment revises section 6851 to provide that a termination assessment does not end the taxable year for any purpose other than the computation of the amount of tax to be assessed and collected. Also, the language relating to reopening of a taxable year is eliminated. This has the general effect of treating amounts assessed and collected pursuant to termination assessments in a manner similar to the collection of estimated taxes. Such an enforced collection, however, is subject to the administrative and judicial review described above, but it does not have the effect of terminating the taxpayer's taxable year. Rather, such taxable year continues until its normal end.

The committee believes it is appropriate to allow a taxpayer who has been subjected to a termination assessment to contest the ultimate issue of his tax liability in the Tax Court in the same manner as is provided with respect to a taxpayer who has been subjected to a jeopardy assessment. Consequently, the committee amendment provides that within 60 days after the later of the due date of the taxpayer's return for the full taxable year or the date on which the return is actually filed, the Service must send the taxpayer a notice of deficiency.[8]

Effective date

These provisions apply to jeopardy and termination assessments where the notice and demand takes place after December 31, 1976.

Revenue effect

These provisions do not have any revenue impact.

5. Administrative Summons (sec. 1205 of the bill and sec. 7609 of the Code)

Present law

Under present law, the IRS is given authority, during the course of an investigation to determine the tax liability of a person, "to examine any books, papers, records, or other data which may be relevant or material" to the investigation. This includes not only the right to examine records in the possession of the taxpayer but also the authority to issue a summons to "any person" having possession or custody of

[7] Thus, for instance, gambling winnings can be offset by gambling losses only within the same taxable year. Consequently, if a gambler were the subject of a termination assessment, he might well be worse off with two short taxable years than a full taxable year. Also, a number of complicated issues might well have to be faced, such as adjusting limitations on the number of taxable years for carryovers and carrybacks (such as those for net operating losses and the investment credit) and problems relating to annualization of the taxoaver's income.

[8] The committee amendment also makes a number of technical changes to the code to conform to the revisions of section 6851(a) and (b) and to clarify the manner in which the tax is computed both where there is one termination assessment in a taxable year and where there are multiple terminations. Thus, for instance, it is provided that certain rules relating to jeopardy assessments also apply to termination assessments, including provisions indicating that the Service has discretionary authority to abate where jeopardy is not shown to exist (even without regard to the review process described above). The requirement of a return for the short period after a termination assessment has been made is repealed, and section 6091 is amended to specifically allow the Service to designate the place for filing returns by taxpayers who have been subjected to a termination assessment. Section 6211(b)(1) is amended to provide that the amounts collected pursuant to a termination assessment are not treated as payments which would be utilized in determining whether there was a deficiency. Further, the rules relating to a bond to stay collection of a termination assessment have been integrated with those relating to jeopardy assessments in section 6863(a).

records "relating to the business of the person liable for tax" as well as the authority to take the testimony of any such person under oath (sec. 7602). In certain cases, where the Service has reason to believe that certain transactions have occurred which may affect the tax liability of some taxpayer, but is unable for some reason to determine the specific taxpayer who may be involved, the Service may serve a so-called "John Doe" summons, which means that books and records relating to certain transactions are requested, although the name of the taxpayer involved is not specified (*United States* v. *Bisceglia*, 95 S. Ct. 915 (1975)). The summonses served by the Internal Revenue Service, which may be referred to as administrative summonses, may be enforced where necessary by appropriate court procedure.

Where the summons is served on a person who is not the taxpayer (i.e., a third-party summons), the party summoned may challenge the summons for procedural defects (i.e., on grounds that the summons is not validly served or is ambiguous, vague or otherwise deficient in describing the material requested), on grounds of the attorney-client privilege (where applicable) and on other grounds, such as an assertion that the material subject to summons is not relevant to a lawful investigation, or that it is not possible for the witness to comply (as where the records are not in his possession). However, there is no legal requirement that the taxpayer (or other party) to whose business or transactions the summoned records relate be informed that a third-party summons has been served.[1]

Reasons for change

The use of the administrative summons, including the third-party summons, is a necessary tool for the IRS in conducting many legitimate investigations concerning the proper determination of tax. The administration of the tax laws requires that the Service be entitled to obtain records, etc., without an advance showing of probable cause or other standards which usually are involved in the issuance of a search warrant. On the other hand, the use of this important investigative tool should not unreasonably infringe on the civil rights of taxpayers, including the right to privacy.

The Service has instituted an administrative policy designed to establish certain safeguards in this area. Under this policy, IRS representatives are instructed to obtain information from taxpayers and third parties on a voluntary basis where possible. Where a third party summons is served, advance supervisory approval is required. In the case of a John Doe summons, the advance supervisory approval must be obtained on a high level basis. The committee believes, however, that these administrative changes, while commendable, do not fully provide all of the safeguards which might be desirable in terms of protecting the right of privacy.

The committee believes that many of the problems in this area would be cured if the parties to whom the records pertain were advised of the service of a third-party summons, and were afforded a reasonable and speedy means to challenge the summons where appropriate. While the third-party witness also has this right of challenge, even

[1] In *United States* v. *Miller*, decided on April 21, 1976, the Supreme Court held that a taxpayer had no protectable Fourth amendment interest in certain bank records maintained pursuant to the Bank Secrecy Act of 1970.

under present law, the interest of the third-party witness in protecting the privacy of the records in question is frequently far less intense than that of the person to whom the records pertain.

In the case of a John Doe summons, advance notice to the taxpayer is obviously not possible. Here the committee decided that the IRS agent should be required to show adequate grounds for serving the summons in an independent review process before a court before any such summons can be served.

Explanation of provisions

Under the committee amendment, in the case of a third-party summons to a bank, brokerage house, accountant, attorney, or other third-party record keeper, the summons is to contain sufficient information so that the record keeper is able to ascertain what books or records are covered by the summons. Such description is to include the identity (if known) of the person pertaining to whose business or transactions the records are kept.

For purposes of these rules, a third party recordkeeper is generally to be a person engaged in making or keeping the records involving transactions of other persons. For example, an administrative summons served on a partnership, with respect to records of the partnership's own transactions, would not be subject to these rules.

Also, under the committee amendment, the Service is to be required to send notice of the summons by registered or certified mail to the person (or persons) who is identified in the description of the books and records contained in the summons as the person relating to whose business or transactions the books or records are kept.[2] For example, if the Service summons a bank to furnish records with respect to all deposits and withdrawals of the X corporation for the year 1976, the X corporation is to receive notice of the summons, because it is the records concerning the transactions of the X corporation which are being examined.[3] Where more than one person is identified in the description of the records as a person the records of whose transactions are to be inspected, then all such persons are to have the right to receive notice under these provisions, and are also to have the right to challenge the summons, as discussed below.

The notice required under these rules is to be mailed not later than 3 days after the administrative summons is served on the third-party record keeper.

The committee also expects that the Service will prepare a summary of the noticee's rights under these provisions, in layman's language, and that a copy of this summary will be enclosed with each copy of the certified notice, so that taxpayers and other noticees will not lose their right to intervention due to inadvertance or ignorance of their rights.

Under the amendment, the Service is not to attempt to obtain the records covered under the summons until the expiration of a 14-day

[2] Such notice is to be sent to the last known business or residential address of the person or persons so identified. (If no address is known, the notice may be left with the third-party record keeper.)

[3] Of course. the Service would not be required to send a notice to each person to whom the X corporation wrote a check during the period under examination; not only would this be impossible administratively, but the identity of these persons would not even be known by the Service until the records had been examined.

period from the date of the mailing of the notice to the taxpayer or other noticee. This is to give the taxpayer (or other noticee)[4] a 14-day period in which to notify the bank or other third-party witness not to comply with the summons. This notification may be in the form of a letter sent by certified or registered mail. A copy of this notice is to be similarly mailed within this same 14-day period to the service officer designated in the notice which the taxpayer receives. The notification by the taxpayer or other noticee is to be treated as timely (within the meaning of sec. 7502) if such notification is mailed within the 14-day period. Where the copy of the notification has not been received by the Service within 3 days from the close of the 14-day period, the IRS would be permitted to presume that the notification had not been timely mailed.

Of course, where the noticee does not request the third-party witness not to comply at this stage, he would still be permitted to assert such defenses as may be available to him with respect to any evidence obtained pursuant to the summons in any later court action in which the noticee was directly involved (i.e. affecting his tax liability or any criminal charges which might be brought) to the same extent as may be permitted under present law.

In case where noticees do exercise their right to request noncompliance by notifying the third-party record keeper and the IRS, as outlined above, the Service is not to seek to inspect the books or records subject to the summons unless the Service goes into court and obtains an order, against the third-party record keeper, for enforcement of its summons. Both the third-party record keeper and the noticee are to be served with notice that an action for enforcement has been instituted.[5] The third-party record keeper could (if it chose to oppose enforceemnt of the order) assert such defenses as may be available to it, just as under present law.

The noticee could also intervene in the action to enforce the summons and assert defenses to enforcement of summons which are available under present law. In addition, the committee intends that the noticee would have standing to raise other issues which could be asserted by the third-party record keeper, such as asserting that the summons is ambiguous, vague or otherwise deficient in describing the material requested, or that the material requested is not relevant to a lawful investigation. In other words, the committee intends that the noticee will be allowed to stand in the shoes of the third-party record keeper and assert certain defenses to enforcement which witnesses are traditionally allowed to claim, but which may not be available to intervenors (under many court decisions) on ground of standing.

At the same time, it should be made clear that the purpose of this procedure is to facilitate the opportunity of the noticee to raise defenses which are already available under the law (either to the noticee or to the third-party witness) and that these provisions are not intended to expand the substantive rights of these parties. Also, of course, the noticee will not be permitted to assert as defenses to en-

[4] Under the committee amendment, the protection of these rules extends even if the person identified in the summons (i.e., the noticee) is not a taxpayer whose tax liability is under current investigation.

[5] Generally, the third-party witness would be served with process. The taxpayer or other noticee would be entitled to receive notice by certified or registered mail.

forcement issues which only affect the interests of the third-party record keeper, such as the defense that the third-party record keeper was not properly served with the summons (i.e., wrong address) or that it will be unduely burdensome for the third-party record keeper to comply with the summons.

The committee does not wish these procedures to so delay tax investigations by the Service that they produce a problem for sound tax administration greater than the one they seek to solve. Accordingly, the committee amendment provides that the disposition of any court actions involved be heard on as expeditious a schedule as possible.

Also, to prevent the use of this procedure by a taxpayer purely for the purpose of delay, the committee amendment provides that in cases where the notice within the meaning of these rules is also the taxpayer whose tax liability is under investigation in connection with the summons, the statute of limitations for assessment of the taxpayer's liability for the period with respect to which the summons relates, as well as the criminal statute of limitations, is to be suspended during the period of any court action by the Service to enforce the summons.[6] Of course, this rule only applies where the noticee has mailed notice to the third-party witness not to comply with the summons. No suspension of the statute occurs where enforcement of the summons is only contested by the third-party record keeper.

In general, these rules apply in th case of a summons issued under paragraph (2) of section 7602 (general examination of books and records) as well as the specific summonses available in connection with certain credits.[7] These rules also apply in connection with testimony to be taken under summons from the third-party witness relating to these books and records.

However, this procedure will not apply in the case of a summons used solely for purposes of collection. Also, this procedure would not apply in cases where the only information requested by the Service was whether or not the third-party record keeper had records with respect to a particular person (without requesting any information contained in those records).

Thus, where the Service has made an assessment or obtaining a judgment against a taxpayer and serves a summons on a bank, for example, in order to determine whether the taxpayer has an account in that bank, and whether the assets in that account are sufficient to cover the tax liability which has been assessed, the Service is not required, under the committee amendment, to give notice to the taxpayer whose account is involved. Also, notice is not required where the Service is attempting to enforce fiduciary or transferee liability for a tax which has been assessed. (Otherwise, there might be a possibility that the taxpayer, transferee or fiduciary would use the 14-day grace period, which is

[6] Of course, closed years would not be reopened under these rules. The committee expects that in the summary of rights which the Service is to send to taxpayers (and other notices), he Service will include a description of he rules relating o the suspension of the statute of limitations, including the specific years which will be affected if the taxpayer requests third-party noncompliance with the summons and the Service subsequently seeks enforcement of its summons. Where the noticee is not the taxpayer under investigation the statute of limitations is not to be suspended, and the summary of rights is to indicate this fact.

[7] These include section 6420(e)(2) (credit for gasoline used on farms), section 6421(f)(2) (credit for gasoline used for nonhighway purposes by local transit systems). section 6424(d)(2) (credit for lubricating oil used in nonhighway motor vehicles), and section 6427(e)(2) (credit for fuels not used for taxable purposes).

provided under the provisions outlined above (to withdraw the money in his account, thus frustrating the collection activity of the Service.) However, this exception does not apply where the Service is attempting to obtain information concerning the taxpayer's account for purposes other than collection as, for example, where the Service is attempting to compute the taxpayer's taxable income by use of the "net worth" method.

The committee amendment also provides a very limited exception to the general rule that the Service is to furnish notice whenever it examines records of the taxpayer which are maintained by a third-party to cover the situation where the Service can demonstrate to a court that compliance with the notice requirement creates a substantial possibility that the noticee may flee, engage in the destruction of records (including those in his own hands) or engage in collusion with or the intimidation of witnesses. The committee contemplates that this will be a relatively unusual procedure, but believes this device should be available for use by the Service in cases where it can be demonstrated, to the satisfaction of a court, that there is a significant possibility that there may be a material interference with the lawful course of an investigation if the taxpayer is informed that his records are under examination.

In the case of a "John Doe" situation, where the Service has knowledge of a particular transaction or transactions which may affect tax liability, but does not know the identity of the person involved, it is obviously not possible to comply with the notice rules outlined above. Typically, when cases like this have arisen in the past, the Service has issued a "John Doe" summons to the third-party record keeper, in which the record keeper is requested to supply all information in its possession relating to such transactions (including any information which the third party may have concerning the identity of the taxpayer).

Recognizing that issues of privacy are involved in connection with the John Doe summons, the Service has made sparing use of this investigative tool. Nonetheless, there are cases where the facts of a particular case are so suggestive of possible tax liability that the Service could be remiss in its duty of collection and enforcement of the Internal Revenue laws if it did not investigate. In some such circumstances, the John Doe summons is the only practical investigative tool which is available.

Under the committee amendment, the Service would be authorized to serve a John Doe summons following a court proceeding in which the Service established, to the satisfaction of the court that (1) the summons relates to the investigation of a particular person or group, (2) there is a reasonable basis for believing that this person or group has failed (or may fail, in the case of an investigation of a current transaction) to comply with the internal revenue laws, and (3) the information sought under the summons is not readily available from other sources and information concerning the identity of the person or group involved is likewise not readily available.

In one reported case in this area, for example, the Service discovered that a number of very old bills had been deposited in a bank, although the identity of the depositor was not known to the Service (*United*

States v. *Bisceglia*, 95 S. Ct. 915 (1975)). The Service has also used the John Doe summons to obtain the identity of the taxpayer where, for example, an accountant has filed a "John and Mary Doe" tax return. In another case, the Service used the John Doe summons to obtain the names of corporate shareholders involved in a taxable reorganization which had been characterized by the corporation (in a letter to its shareholders) as a nontaxable transaction. In these, and similar situations, where there are unusual (or possibly suspicious) circumstances, and the Service needs to learn more details of the situation in order to determine whether tax liability should be assessed against some person (as well as the identity of the person who may be liable for tax), use of the John Doe summons may be appropriate.

While the committee believes it is important to preserve the John Doe summons as an investigative tool which may be used in appropriate circumstances, at the same time, the committee does not intend that the John Doe summons is to be available for purposes of enabling the Service to engage in a possible "fishing expedition." For this reason, the committee intends that when the Service does seek court authorization to serve John Doe summons, it will have specific facts concerning a specific situation to present to the court.

On the other hand, the committee does not intend to impose an undue burden on the Service in connection with obtaining a court authorization to serve this type of summons. For example, the Service is not required to show that there is "probable cause" (within the meaning of the criminal laws relating to the issuance of a search warrant) to believe that a criminal act has occurred, or even that civil fraud has occurred, or might be involved. It is enough for the Service to reveal to the court evidence that a transaction has occurred, or may have occurred, and that the transaction (in the context of such facts as may be known to the Service at that time) is of such a nature as to be reasonably suggestive of the possibility that the correct tax liability with respect to that transaction may not have been reported (or might not be reported in the case of a current year transaction, with respect to which a return is not yet due). Also the Service must convince the court that it has made a good faith, reasonable effort to explore other methods of investigation, and that use of the John Doe summons is the only practical means of obtaining the information contained in the records described in the summons.

In such circumstances, issuance of a court order authorizing use of the summons would be appropriate. Of course, the summons, when served, is to describe the particular information needed by the Service with respect to that transaction with as great a specificity as possible, in order to minimize the burden on the third-party record keeper.

The committee contemplates that the court will review each John Doe summons to be sure that the material requested is reasonably related to the investigation, and that the summons is not overly broad in terms of the records requested.

The committee amendment also contains a provision which would authorize the Service to reimburse witnesses for the costs of complying with administrative summonses. Under these provisions the Service is required to pay per diem and mileage costs when a witness is required to appear in response to a summons and would authorize the

Service to reimburse a summoned party (other than the taxpayer or his representatives) for direct costs incurred in locating, copying and transporting any summoned records (other than records in which the taxpayer has a proprietary interest). Such payments and reimbursements are to be at rates, and subject to such conditions, as may be prescribed in regulations.

The committee amendment is generally similar to the House bill. However, the provisions allowing the Service a 3-day grace period to mail notice to the taxpayer, providing for a suspension of the criminal statute of limitations where the summons is protested by the taxpayer, and suspending the notice requirement where the summons is solely to determine if records exist, or where notice may result in a material interference with an investigation, as well the rules on reimbursement of witness costs, were added by the committee amendment.

Effective date

These amendments are to apply to summonses issued after December 31, 1976.

Revenue effect

These provisions do not have any revenue impact.

6. Assessments in Case of Mathematical or Clerical Errors (sec. 1206 of the bill and sec. 6213 of the Code)

Present law

Under present law (sec. 6213(a)), in general, the Internal Revenue Service must send the taxpayer a notice of deficiency and provide the taxpayer an opportunity to petition the Tax Court before the Service can assess a deficiency of income, estate, or gift tax or of a tax imposed under the private foundations provisions (chapter 42) or under the provisions relating to qualified pension, etc., plans (chapter 43). An exception under present law permits the Service to summarily assess any additional tax resulting from correction of "a mathematical error appearing on the return" (sec. 6213(b) (1)). In such a case, the Service is not required to send a notice of deficiency to the taxpayer, nor does the taxpayer have a right to judicial review (through a Tax Court petition) before being required to pay the tax.

Where the Internal Revenue Service determines that a mathematical error has been made and, as a result, the taxpayer owes additional tax, an assessment is summarily made, and a notice of mathematical error which describes the error is sent to the taxpaver. Under the Service's policy, before it begins to collect the individual tax due on account of the apparent error, the Service permits the taxpayer to explain why he or she believes there is no error. If the taxpayer substantiates the claim, the Service's policy is to abate any assessment which it may have made or refund any additional tax which the taxpaver may have paid. Under present law, however, a taxpayer has no right to claim abatement of any income, estate, or gift tax (sec. 6404 (b)).

The term, mathematical error, has been interpreted by the Service to include several types of error which are broader in nature than literal errors of arithmetic. The Service position is that mathematical error includes the following: errors in arithmetic (such as 2+2=5);

errors in transferring amounts correctly calculated on a schedule, form, or another page of Form 1040 to either page 1 or page 2 of Form 1040; missing schedules, forms, or other substantiating information required for inclusion with Form 1040; inconsistent entries and computations (such as cases where total exemptions claimed do not agree with the total used in computing the tax); and errors where the entry exceeds a statutory numerical or percentage limitation (such as a standard deduction claimed in excess of the maximum allowed by the Code).

Court opinions, however, generally have limited the scope of the term, mathematical error, to arithmetic errors involving numbers which are themselves correct.

Reasons for change

Questions have been raised as to whether the Service has used its mathematical errors summary assessment powers in cases where their use is not authorized by the statute. The Service maintains that it properly uses this procedure in categories of cases where most taxpayers do not dispute the Service's conclusions, thereby substantially reducing administrative and other costs.

The Service has stated that the deficiency notice procedure is significantly more costly than the mathematical error procedure, both in terms of personnel and processing costs and in terms of the cost to the Government of delays in collection of taxes. On the other hand, the committee has concluded that the Service should not be able to proceed summarily where the Service may have erred in its determination.

In balancing these considerations, the committee decided (1) to provide greater protection for taxpayers who wish to contest Internal Revenue Service summary assessments in mathematical error cases, by restricting the Service's powers in such cases, and (2) to clarify the kinds of cases in which the Service could use this restricted summary assessment authority.

Explanation of provision

The amendment provides that where the Internal Revenue Service uses the summary assessment procedure for mathematical errors (changed to "mathematical or clerical errors" under the amendment), the taxpayer must be given an explanation of the asserted error (sec. 6213(b)(1)), the taxpayer must be given a period of time during which he or she may require the Service to abate its assessment (sec. 6213(b)(2)(A)), and the Service is not to proceed to collect on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to expire (sec. 6213(b)(2)(B)). The House bill is essentially the same as the committee amendment, except for the effective date and the period during which the assessment may be reauired to be abated.

Definition.—The bill defines the term "mathematical or clerical error" (sec. 6213(f)(2)) to mean—

(1) an error in addition, subtraction, multiplication, or division shown on the return;

(2) an incorrect use of an Internal Revenue Service table if the error is apparent from the existence of other information on the return;

(3) inconsistent entries on the return;

(4) an omission of information required to be supplied on the return in order to substantiate an item on that return; and

(5) entry of a deduction or credit item in an amount which exceeds a statutory limit which is either (a) a specified monetary amount or (b) a percentage, ratio, or fraction—if the items entering into the application of that limit appear on that return.

Arithmetic errors.—Examples of errors in addition, subtraction, etc., include 2+2=5 and 7−0=0. In the usual case, such an error will be apparent and the correct answer will be obvious. However, care should be taken to be sure that what appears to be an error in addition or subtraction is not in reality an error in transcribing a number from a work sheet, with the final figure being correct even though an intermediate arithmetical step on the return appears to be wrong. For example, there may appear to be an error on the Form 1040 in subtracting itemized deductions (line 44) from adjusted gross income (line 43), resulting in an understatement of taxable income (line 47). However, examination of the return may show that the correct total of itemized deductions (itemized on schedule A) would result in the taxable income shown by the taxpayer on the Form 1040. The examination in such a case might reveal the error to be a transcription error which did not affect tax liability. It is expected that the Service will check such possible sources of apparent arithmetical errors before instituting the summary assessment procedures.

Use of tables.—An example of an incorrect use of a table is the use of a tax rate schedule X (single taxpayers) by a person who has checked line 3 of the 1975 Form 1040, indicating that the taxpayer is "married filing separately." Such a person should use the generally higher tax figures in the right-hand portion of tax rate schedule Y. In such a case, it is expected that the notification to the taxpayer will indicate that the taxpayer used the single person's rate schedule, that the taxpayer checked line 3 on the Form 1040, that such a taxpayer should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule). The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married. For example, a person legally separated from his or her spouse may be treated as not being married for purposes of the Internal Revenue Code (sec. 2(c)) and therefore may be entitled to use the single person's schedule or the even more favorable head of household schedule (schedule Z).

Inconsistent entries.—Care must be taken in administering the next category—inconsistent entries on the return. This category is intended to encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect. For example, if the taxpayer's entries as to personal exemptions on lines 6a, b, c, d, and e of Form 1040 add up to the total stated on line 7 (for example, assume that the total is "6," correctly added), but the taxpayer on line 46 of Form 1040 multiplies $750 by a different number (for example, "7"), then the Service is justified in regarding this as an error and correcting the error by multipliying the $750 for each exemption by, in the case cited above, "6." Even in this case, however, the committee expects that the Service will so phrase its notification to the taxpayer as to include questions designed to show whether the taxpayer indeed is entitled to the greater number of exemptions indicated on line 46 rather than the lesser number of exemptions indicated on line 7.

However, the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one. For example, line 6b of the Form 1040 requires the taxpayer to list, "First names of your dependent children who lived with you" and then to enter the number of those dependent children in a column for personal exemptions. If a taxpayer lists three names on line 6b but then enters "4" in the column, it is not clear whether the taxpayer miscounted (in which case the taxpayer should have written "3" in the column) or whether the taxpayer erroneously omitted the name of one of the dependent children (in which case the taxpayer's column-entry of "4" would be correct). In this case, the Service should, of course, take steps to determine which entry is correct, and the taxpayer has the obligation of showing that he or she is entitled to the number of exemptions claimed. However, this summary assessment procedure is not to be used where the Service is merely resolving an uncertainty against the taxpayer.

Omissions of supporting schedules.—The next category is "an omission of information which is required to be supplied on the return to substantiate an entry on the return". The intent of this provision is to deal with situations where items should be supported by schedules which are part of the return. For example, if deductions are itemized (rather than the taxpayer taking the standard deduction), Schedule A should be included with the return. Similarly, Schedule G should be included if the taxpayer claims the benefits of income averaging. Also, Form 4726 should be included if the taxpayer claims the benefits of the maximum tax. Where the necessary supporting schedule is omitted from the return, then the Service may proceed under this provision by disallowing the beneficial treatment—unless the taxpayer supplies the necessary schedule. Here, too, the notification by the Service should be so designed as to encourage the taxpayer to supply the omitted schedule. If the taxpayer supplies the omitted schedule, then this justification for use of the summary assessment procedure is no longer applicable, and the supplying of the schedule is to be treated as a request for an abatement of the summary assessment. If the omitted schedule itself presents other mathematical or clerical errors (such as errors in addition or inconsistent entries), then this may be a justification for initiating a new summary assessment procedure based on those asserted errors.

Exceeding statutory limits.—The fifth category deals with deduction or credit items that exceed the statutory limit, where this is apparent from the return. This category of error occurs, for example, where a taxpayer (other than a married taxpayer filing a joint return) takes a dividend exclusion of more than $100 ($200 for joint returns) or more than the amount of the otherwise taxable dividends (sec. 116). However, this category of mathematical or clerical error does not extend to a dispute as to whether a given dividend qualifies for the exclusion (e.g., the exclusion does not apply to dividends from foreign corporations, China Trade Act corporations, real estate investment trusts, etc.). Another example of an error that falls into this fifth category is the claiming of a standard deduction greater than the dollar or percentage limits applicable to that taxpayer. (See the percentage standard deduction and low income allowance provisions of sec. 141.)

In the categories of cases that the committee has dealt with in this amendment, not only is the error apparent from the face of the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return.[1]

Abatement.—The amendment (new sec. 6213(b)(2)) provides that a taxpayer who receives notice of an assessment for additional tax has 60 days (from the date the notice was sent) to file a request for an abatement of the assessment stating the disagreement with the amount of the assessment.

If the taxpayer sends such a request to the Service within the prescribed time limit, the Service must abate the assessment. During this 60-day period, the Service is not to proceed to collect upon this summary assessment. Of course, if the assessment is abated, then it never will be collected upon.

Effective date

The new summary assessment rules, together with the rights of taxpayers to require abatement of any assessments made under those rules, are to apply to income, estate, gift, private foundation, and pension tax returns filed after December 31, 1976.

Revenue effect

It is estimated that this provision will have no revenue effect.

7. Withholding Tax Provisions

a. Withholding of State and District Income Taxes for Military Personnel (sec. 1207 of the bill and secs. 5516 and 5517 of title 5, U.S.C.)

Present law

Under present law, the Secretary of the Treasury is required to enter into agreements with States which request it to withhold State income tax from Federal employees. These agreements may not apply to members of the Armed Forces.

Reasons for change

The absence of withholding has created problems for servicemen who may not know that they are subject to State income tax and may be assessed with a large deficiency when they return from active duty. In addition, in the absence of withholding, many members of the Armed Service have difficulty making the lump sum payments required when complying with the State tax on an annual basis. There is considerable support among servicemen and other concerned groups

[1] It may be argued that the category of omissions of supporting schedules departs from this general approach. As indicated above, the summary assessment in such a case is to be abated when the omitted schedule is supplied by the taxpayer: disputes as to the adequacy of the schedule that the taxpayer submits are to be dealt with under normal administrative procedures and not by use of the extraordinary summary assessment procedure (unless one of the other "mathematical or clerical errors" categories applies).

for providing withholding of State income taxes for members of the Armed Forces.

In June 1974, the National Association of Tax Administrators (NATA) unanimously decided to advise the Federal Government of the States' desire for withholding of State income taxes from military pay. In 1975, the General Accounting Office (GAO) report on this question, Report to the Congress, By the Comptroller General of the United States, "A Case for Providing Pay-as-You-Go Privileges to Military Personnel for State Income Taxes", points out that, on the basis of a limited study of compliance with State income tax by military personnel in the Washington metropolitan area (covering the income taxes of all three jurisdictions) the compliance with these income taxes by legal residents of these jurisdictions was inadequate. The report states in part:

"The Congress should enact legislation to provide military personnel with pay-as-you-go privileges for State income taxes. Laws which permit these taxes to be withheld from Federal civilian pay prohibit such withholding on military pay. . . .

"DOD cited administrative difficulties and costs of accomplishing withholding as its principal objections. GAO recognizes it would cost the Federal Government to withhold State income taxes from military pay but similar withholding is being done with respect to civilian employees of Federal agencies and by private firms having operations national in scope."

In November 1975, the Advisory Commission on Intergovernmental Relations recommended a change in the law to provide mandatory withholding of State income taxes from military personnel. As pointed out in the October staff report on which this recommendation was based, the compliance with State income tax by military personnel is not good. As the report noted, "The absence of tax withholding contributes to the military member's uncertainty about his income tax obligation; it also makes payment of taxes more difficult and increases the temptation not to file a tax return." The report further pointed out, "The absence of withholding also complicates the enforcement process for States and local governments." The report indicated that even under the arrangement whereby the military reports payroll information for military personnel to the States, compliance is poor and the information is not adequate. The report further noted that if withholding is adopted, it will impose additional costs on the military (but no more than on any private employer) and, accepting the military's estimate of $4.7 million annually to operate the system, this is only $2.50 per serviceman per year.

The Office of Management and Budget (OMB) has expressed approval of withholding as indicated in its August 12, 1975 letter to the GAO, which said in part:

> "There is no question that the present system of withholding state and local taxes from pay of Federal civilian employees has proved to be beneficial both to the employee and to the states and local municipalities. This system makes it easier for individuals to meet their tax obligations and it also facilitates the receipt of revenues that appropriately belong to the affected states. We believe similar benefits would be forthcoming if such

> a withholding system was applied to military pay and that the Federal Government should provide whatever assistance is necessary to assure that such a system is developed and implemented."

As a result of these concerns, the committee believes it is appropriate to provide for the withholding of State income taxes for members of the Armed Forces.

Explanation of provision

The committee amendment amends section 5516 and 5517 of title 5 of the U.S.C. to eliminate the prohibition against the Secretary of the Treasury entering into agreements with States and the District of Columbia to withhold State income taxes from members of the Armed Services. Thus, the Secretary of the Treasury will be required to enter into agreements to withhold State and District income taxes from members of the Armed Forces when the States and District request such withholding from military personnel who are liable for such tax.

The committee expects that the Secretary of the Treasury will consult with the Department of Defense and other concerned agencies in designing such agreements in view of the fact that DOD will do the actual withholding since it, not the Treasury, is the paying agent and in view of the special problems that are involved in establishing the residence for tax purposes of military personnel.

These changes do not in any way affect, or imply any change in, the existing rules which determine the situs for State income tax purposes of a member of the Armed Forces. They do not in any way imply that a State in which a member of the Armed Forces is stationed but of which he is not a resident for tax purposes may assert jurisdiction over such person. In other words, the existing rules for liability for State income tax of members of the Armed Forces are left unchanged but withholding from individuals who are members of the Armed Forces and liable for these income taxes is provided.

The committee expects that the Department of Defense will contribute to the effective implementation of this provision by making a greater effort to instruct members of the Armed Forces in their possible liability for State income taxes and the requirements of withholding in cases where they are liable for such tax.

The committee also expects that the Secretary of the Treasury and the Department of Defense will develop procedures for determining the residence for tax purposes of military personnel within the context of agreements the Secretary of the Treasury enters into with the States.

The burden imposed on the military by the withholding requirement is not regarded as being more burdensome than that imposed on private employers. Once the system is established for the military withholding, its operation should not be significantly more burdensome on the military than the rules applicable to private employers. The purpose of this requirement was to prevent discrimination against the United States (as to employees) by the States. The Congress believes that this withholding is a burden which the United States should assume, both for the States and for the military and their families. Therefore, any difference in burdens is not one which comes within the purview of the requirement.

The House bill contained a similar provision as the committee's amendment, except that the House provision applied when the military service personnel requested withholding.

Effective date

This amendment contains its own effective date in that sections 5516 and 5517 (5 U.S.C.) require the Secretary to enter into a withholding agreement 120 days after the request from the proper State official and such request cannot be made until after the date of enactment of this provision.

Revenue effect

This amendment has no effect on the Federal revenues, but is expected to improve the effectiveness of individual income tax collection by the States and the District of Columbia.

b. Withholding State and City Income Taxes From the Compensation of Members of the National Guard or the Ready Reserve (sec. 1207 of the bill and secs. 5516, 5517 of title 5, U.S.C.)

Present law

Under present law, the Secretary of the Treasury is required to enter into agreements with States and cities to withhold State and city income taxes from the compensation of Federal employees. The agreement, however, may not apply to pay for service as a member of the Armed Forces.

Reasons for change

In the case of members of the National Guard or Ready Reserve who are serving in this status within the State of which they are a resident, the inability of the Federal Government to withhold State income tax from their compensation often means they are faced either with large lump-sum payments at the time of filing or they must make a declaration of estimated tax and pay the tax quarterly. This is the same problem which led to the adoption of the Federal withholding of State income tax provision in the first instance.

Explanation of provision

The committee amendment extends the provision under present law requiring the Treasury to enter into agreements with States, the District of Columbia and cities to withhold income taxes from Federal employees to members of the National Guard and Ready Reserve when they are paid for performing regular training. The House bill provision is identical to the committee amendment.

Effective date

The present law provision which is amended by this amendment contains its own effective date in that section 5517 (5 U.S.C.) requires the Secretary to enter into a withholding agreement 120 days after the request from the proper State official and such request cannot be made until after the date of enactment of this provision.

Revenue effect

This provision has no effect on Federal revenues.

c. *Voluntary Withholding of State Income Taxes From the Compensation of Federal Employees (sec. 1207 of the bill and sec. 5517, title 5, U.S.C.)*

Present law

Under present law, the Secretary of the Treasury is required to enter an agreement with a State to withhold State income tax from Federal employees in the State only if withholding State income tax is generally required of employees. The Secretary cannot enter such agreements in States where the withholding is voluntary.

Reasons for change

The prohibition against the Secretary of the Treasury entering into withholding agreements with States unless the requirement is imposed generally was designed to prevent States from imposing more stringent requirements on the Federal Government than they imposed on other employers who operated in the State. If withholding is voluntary in the case of both private employers and the Federal Government, no discrimination between them exists and the committee sees no reason to prohibit the Federal Government from withholding State income tax from its employees.

Explanation of provision

The amendment permits the Secretary of the Treasury to enter into agreements with States to withhold State income taxes from Federal employees in those States where such withholding is voluntary. There is no comparable provision in the House bill.

Effective date

This provision has the same effective date as (b) above.

Revenue effect

This provision has no effect on Federal revenues.

d. *Definition of City for Purposes of Withholding City Income Tax From Federal Employees (sec. 1207 of the bill and sec. 5520 of title 5, U.S.C.)*

Present law

Under present law, the Secretary of the Treasury is required to enter into agreements to withhold city income or employment taxes from Federal employees for incorporated cities with 500 or more Federal employees.

Reasons for change

There are some jurisdictions (for example, townships, and city-county governments) that impose income or employment taxes but are not incorporated cities. Consequently, the Federal Government may not withhold the taxes imposed by these jurisdictions from the pay of Federal employees. The committee believes the current definition of "city" is imposing an unintended restriction on the Federal withholding of local taxes and the definition should therefore be broadened.

Explanation of provision

The committee amendment broadens the definition of city to encompass similar jurisdictions that are not defined as incorporated cities. This provision is the same as H.R. 10572, which passed the House on May 3, 1976. There is no comparable provision in the House bill.

Specifically, the amendment broadens the definition of city to include any unit of general local government which is either classified as a municipality by the Bureau of the Census or is a town or township which, according to the Secretary of Treasury, meets the following criteria:

> "(1) it possesses powers and performs functions comparable to those associated with municipalities,
>
> "(2) it is closely settled, and
>
> "(3) it contains within its boundaries no incorporated places, as defined by the Bureau of the Census, within the political boundaries of which 500 or more persons are regularly employed by all agencies of the Federal Government".

Effective date

The application of this provision has the same effective date as mentioned in (b) above.

Revenue effect

This provision has no effect on Federal revenues.

e. Withholding Tax on Certain Gambling Winnings (sec. 1207 of the bill and sec. 3402 of the Code)

Present law

Under present law, withholding on racetrack winnings is not required although payouts to winners of the daily double, Exacta, Perfecta and similar type pools are reportable on Form 1099 information returns if the payout is based on betting odds of 300 to one or higher.

The regulations require that winnings be reported on 1099's whenever the winnings are $600 or more from a $2 bet because it is not practical to enforce reporting for odds lower than 300 to 1.

In addition, Nevada gambling casinos are required to report certain large winnings from Keno and bingo games on Form 1099 to the Internal Revenue Service depending on the price of ticket as well as the amount won.

Reasons for change

Although most wagering transactions have no tax significance since the majority of bettors end up the year with no net wagering gains, the special types of wagers mentioned above represent unique and occasional windfalls that generally produce a significant tax liability. Even with the information reporting requirements, many taxpayers do not report these winnings on their income tax returns. One source of this nonreporting of income is, for example, the use of the so-called "10 percenters" at the racetrack. A 10 percenter is a person hired by the winner to cash his ticket for 10 percent of the winnings and provide fictitious identification so that the reporting on Form 1099 is provided in a name other than that of the actual winner. These 10 percenters themselves seldom pay any income tax either by filing no tax return or claiming sufficient offsetting losses.

Explanation of provision

To deal with the underreporting of gambling winnings, the committee amendment supplements the information reporting requirement with a provision for withholding on certain winnings at a 20-percent withholding rate. The House bill provision is identical to the committee amendment except for the effective date.

The person making the payment of winnings subject to withholding would be required to deduct and withhold from the payment 20 percent of such payment. The withholding would be based on the entire payment rather than the amount of the winnings for ease of compliance. The winnings subject to withholding would be the proceeds of more than $1,000 from wagers in sweepstakes, wagering pools, or lotteries (whether or not conducted by a State or agency or instrumentality of a State). In the case of winnings other than those mentioned above, withholding is to be required on payments of more than $1,000 from the wagering transaction if the amount of such proceeds were at least 300 times as large as the amount wagered. This withholding requirement would also apply to winnings over $1,000 from slot machines. This type of winning is no different from other games of chance with large payoffs because, in case of slot machines, when a payoff in excess of $1,000 occurs, the winner is paid by check or cash at the cashier's window rather than by, for example, in the case of a quarter machine, 4,000 quarters being paid out of the machine itself.

The nerson who is to rereive the pavment of winnings subject to withholding would be required to furnish the payor with the name, address and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment. under penalty of perjury.

Effective date

These new withholding rules are to apply to wagering transactions occurring 30 days after the enactment of this Act.

Revenue effect

This provision will increase budget receipts by $124 million in fiscal year 1977, $78 million in fiscal year 1978, and $78 million in fiscal year 1981.

f. Treatment of Certain Individuals Employed in Fishing as Self-Employed Individuals (sec. 1207 of the bill and new sec. 3121(b)(20) of the Code).

Present law

Under the present law, the Internal Revenue Service usually treats individuals employed on fishing boats, or on boats engaged in taking other forms of aquatic animal life, as regular employees. As a result, operators of the boats must withhold taxes from the wages of these crewmen, and must also deduct and pay the taxes on employees and employers under the Federal Insurance Contributions Act (the social security taxes).

Reasons for change

The crews that work on boats used in fishing and similar pursuits. such as taking shrimp and lobsters, are frequently "pickup" crews composed of individuals who may work for only a few voyages, and sometimes even for only one voyage. In some cases. the boat operator may select his crew from individuals found waiting on the dock in the morning. In still other cases, small boats may be operated by relative, no one of whom is considered the boat operator. "captain," or even the crew's leader. Thus, the voyage partakes more of the nature of a joint venture than it does of an employment situation.

Under these circumstances, it is difficult and impractical for the boat operator to keep the necessary records to calculate his tax obligations as an employer, and it is equally difficult for him to withhold the appropriate taxes for payment. Often these boats operate with small crews, and the boat operator himself is likely to be an individual who has worked as a fisherman throughout his career, and who is unaccustomed to keeping records of any type, especially the type required under the tax rules for employers.

Another factor contribution to the difficulty in which such boat operators find themselves is the nature of the remuneration paid to their crewmen. In many cases, the crewmen are paid no regular salary, but instead receive a portion of the catch. In practice, the catch is often sold upon return to shore, usually by the boat operator, and each crewman is immediately paid a percentage of the proceeds of the catch that is equivalent to the portion of the catch for which he agreed to work. In view of the basic informality of these arrangements, and the consequent difficulty in adhering to the obligations required of employers by the Internal Revenue Code, the committee believes it appropriate to remove these obligations from certain small boat operators by treating their crewmen as self-employed individuals. The committee believes that this will recognize the basic nature of the arrangement between the boat operators and the crewmen since the crewmen. under these arrangements, should find it much simpler and more convenient to calculate and report their own income for tax purposes than do the boat operators.

In treating these situations as instances of employment of crewmen by boat operators, the Internal Revenue Service has not only required current payment of employment taxes by the boat operators, but has also assessed these taxes retroactively for all tax years still open under the statute of limitations. As a result of possibly sizeable assesments, many boat operators may face bankruptcy.

Explanation of provision

The committee amendment provides that boat crewmen, under certain circumstances. shall be treated as self-employed for purposes of income tax withholding from wages, the self-employment tax, the Federal Insurance Contributions Act taxes. and the social security laws. Crewmen are to be treated as self-employed if their only remuneration is a share of the boat's catch and if their employment on the boat is on a "substantially intermittent basis" (to be defined by Treasury regulations). In addition. they are to be treated as self-employed only if the operating crew of the boat normally consists of fewer than six individuals (including the captain). Of course, a crewman who is self-employed by virtue of this provision for one voyage may work as a regular employee in a subsequent voyage during the same tax period on another boat, or conceivably even on the same boat. Therefore, such an individual may be both self-employed and a regular employee in his occupation as a fisherman (or in such a similar pursuit as taking lobsters or shrimp) during the same tax period.

To achieve this, the committee provision amends the definitions of employment (sec. 3121(b) of the Code), the definition of a trade or business (sec. 1402(c)), and the definition of wages for purposes of withholding (sec. 3401(a)). In addition, amendments are made to the definitions of employment and of a trade or business in the parallel social security statutes.

This provision alleviates many of the recordkeeping requirements of the small boat operators. However, in order to permit the Internal Revenue Service to maintain a method of insuring that the crewmen to be treated as self-employed correctly report their income, the committee amendment also requires boat operators to report the identity of the self-employed individuals serving as crewmen, as well as the portion of the catch allotted to that individual. In addition, in order to allow the Service to compute the total proceeds of the catch, if necessary, the boat operator is also to report the percentage of his own share of the catch. Furthermore, such a boat operator is also to provide each of the self-employed crewmen a written statement on or before January 31 of the succeeding year showing the information reported by the boat operator with respect to that crewman for the preceding calendar year. Of course, this requirement must be contingent upon the crewman's supplying the boat operator with a location at which the crewmen will receive the written statement.

The House bill contains no comparable provision.

Effective date

The provisions providing for tax treatment of crewmen as self-employed when employed under the circumstances described above are to be effective with respect to services performed after December 31, 1971, in taxable years ending after that date. The provisions pertaining to the new reporting requirements of boat operators apply to calendar years beginning after December 31, 1971.

Revenue effect

It is estimated that this provision should have little impact upon tax revenues.

8. State-Conducted Lotteries (sec. 1208 of the bill and secs. 4402 and 4462(b) of the Code)

Present law

Under present law, each person engaged in the business of accepting wagers is subject to an excise tax of 2 percent on the amount of wagers placed with that person (sec. 4401). The excise tax on wagers generally applies to any person who is conducting a lottery. In addition, a related occupational tax of $500 per year is imposed on each person who is liable for the tax on wagers (or who is engaged in the business of receiving wagers for or on behalf of a person who is in turn, liable to pay the excise tax on wagers) (sec. 4411). Also, a special occupational tax of $250 per year is imposed on the operation of coin-operated gaming devices, including a vending machine which dispenses tickets on lotteries (sec. 4461). An exemption from the wagering tax is provided for sweepstakes or lotteries conducted by an agency of a State and in which the ultimate winners are determined by the results of a horse race.

Reasons for change

In 1963, New Hampshire became the first State in recent history to establish a State lottery. The lottery was similar in operation to the Irish Sweepstakes, so that the lottery's ultimate winners were determined by the results of a designated horse race, which was run following a preliminary selection of the prospective winners by lot. The lottery, when established, was subject to the Federal tax on wagering. In 1965, however, Congress provided an exemption from this tax in the case of State-conducted sweepstakes, wagering pools, or lotteries. The exemption was specifically based upon the New Hampshire-type of lottery and has two basic requirements: (1) the sweepstakes, wagering pool, or lottery must be conducted by an agency of a State acting under authority of State law; and (2) the ultimate winners must be determined by the results of a horse race (sec. 4402(3)).

Since the appearance of the New Hampshire lottery, several other States have established and are operating lotteries. Several more States have either authorized, or are investigating the feasibility of lottery operations. The lotteries which have been established since 1965, including a revised version of the New Hampshire lottery, differ substantially in the manner in which they operate from the form of lottery which was made exempt by Congress in 1965. Although most States use a format which gives the appearance that the ultimate winners are determined on the basis of a horse race, as a matter of fact, ultimate winners are determined by lot. Consequently, the lotteries, as now conducted, do not satisfy the second requirement for exemption from the tax on wagers. that is. the use of a horse race to determine the winners.

The committee believes that the exemption of State lotteries from the excise tax on wagers should be expanded to include the types of lotteries now generally used by States.

Explanation of provision

The committee amendment deletes the requirement that the ultimate winners of State lotteries must be determined on the basis of the results of a horse race. Accordingly, all State lotteries will be exempt from the wagering tax regardless of the method used for determining the winners. Furthermore, since lottery tickets may be dispensed through coin-operated vending machines, the provision also adds a similar exemption from the special occupational tax on the operation of veding machines for State-run lotteries. The House bill provision is identical to the committee amendment.

Effective date

Sine the committee believes that none of the Federal taxes on wagering were intended to be imposed on State-run lotteries the changes refered to above are to be effective for wagers made, or for periods, after March 10, 1964.

Revenue effect

This provision will forestall the collection of as yet uncollected Federal wagering taxes on State lotteries. It is estimated that the uncollected amount, which the committee believes should not be and was not intended to be a tax liability, amounts to about $200 million.

9. Minimum Exemption from Levy for Wages, Salary, and Other Income (sec. 1209 of the bill and secs. 6331, 6332, and 6334 of the Code)

Present law

Present law (sec. 6334 of the Code) enumerates a relatively limited list of items of a taxpayer which are exempt from levy for taxes. The items so exempt are generally as follows: (1) wearing apparel and school books necessary for the taxpayer or members of his family; (2) if the taxpayer is the head of a family, up to $500 worth of the following: The fuel, provisions, furniture, and personal effects in his household, arms for personal use, livestock, and poultry; (3) up to $250 worth of books and tools necessary for the taxpayer's trade, business or profession; (4) unemployment benefits (including any portion payable with respect to dependents); (5) undelivered mail; (6) annuity or pension payments under the Railroad Retirement Act, benefits under the Railroad Unemployment Insurance Act, special pension payments received by a person whose name has been entered on the Army, Navy, Air Force, and Coast Guard Medal of Honor roll, and annuities based upon retired or retainer pay under the Retired Serviceman's Family Protection Plan; (7) workmen's compensation payments (including any portion payable with respect to dependents); and (8) so much of the taxpayer's salary, wages, or other income as is necessary to comply with a pre-levy court-ordered judgment for support of his minor children.

Under present law, a levy extends only to obligations which exist at the time of levy (sec. 6331(b)). Consequently, the Internal Revenue Service can levy only on salaries and wages which have been earned as of the date of the levy.[1] If the amount of such wages or salary levied upon is inadequate to satisfy the taxpayer's obligations, the Internal Revenue Service may utilize successive levies against additional salary or wages of a taxpayer until those obligations have been satisfied.

Reasons for change

Since no portion of a taxpayer's salary or wages is exempt from levy (except for court-ordered child support payments), but unemployment compensation is exempt, an employed taxpayer who is subject to a levy is substantially worse off than an unemployed taxpayer would be under similar circumstances. In the case of an employed taxpayer subject to a levy, it appears desirable not to encourage him to terminate his employment but rather to continue his job. As a consequence, the committee concluded that a minimum amount of a taxpayer's salary, wages or other income should be exempted from levy

[1] Under section 6331(d), except in the case of jeopardy, an initial levy may be made on the salary or wages of an individual only after he has been notified in writing that such a levy is going to be made.

and such amount should be based in part upon the number of dependents of the taxpayer.

The committee further believes that the requirement of successive levies in the case of salary and wages results in substantial administrative problems for the Internal Revenue Service and does not afford individual taxpayers any significant benefit.

Explanation of provision

The committee amendment provides an exemption from levy for a minimum amount of an individual's wages or salary for personal services, or income derived from other sources. The amount, in the case of an individual who is paid on a weekly basis, is $50 per week plus $15 per week for each of his dependents (other than any minor child of the taxpayer with respect to whom an amount is exempted from levy as a court-ordered support payment). Individuals who are paid on other than a weekly basis shall have, as nearly as possible, an equivalent amount exempt from levy under regulations to be prescribed by the Secretary of the Treasury. In order to deter taxpayers from claiming more dependents than those to which they are entitled, the taxpayer will have to verify the number of his dependents.

The amendment provides that a levy on salary or wages of a taxpayer is to be continuous from the date the levy is first made until the tax liability with respect to which it is made is satisfied or becomes unenforceable because of the lapse of time.[2]

The amendment also provides that the Internal Revenue Service must release the levy as soon as possible after the liability out of which such levy arose is either satisfied or becomes unenforceable by reason of lapse of time and is to promptly notify the person upon whom the levy was served (normally the employer) that the levy has been released.

The House bill is essentially the same as the committee amendment, except for a change in the effective date.

Effective date

These provisions are to apply with respect to levies made after December 31, 1976.

Revenue effect

This provision is not expected to have any revenue effect.

10. Joint Committee Refund Cases (sec. 1210 of the bill and secs. 6405 and 8023 of the Code)

Present law

One of the statutory duties of the Joint Committee on Taxation in investigating the operation and effect of the Federal tax laws is the review of cases involving refunds of income, war profits, excess profits, estate and gift taxes in excess of $100,000. (Code secs. 6405(a), 6405(c), and 8022.) Except for tentative refunds under section 6411, the code forbids payment of such refunds until at least 30 days have passed after an administrative report has been submitted to the Joint Committee.

[2] A conforming amendment is made to section 6332.

Reasons for change

The present $100,000 jurisdictional amount for refund cases which are reviewed by the Joint Committee has remained at that level for over 30 years. As a result of inflation and other factors, the number of refund reports reviewed by the Joint Committee in recent years has increased substantially. For example, in 1970 there were 647 refund reports while in 1975 this number increased by over twofold to 1,434 reports. The committee is aware that the review of these reports by the Joint Committee is confined only to those cases for which large refunds have been proposed or allowed and that it does not allow any general review of specific issues or cases in which large refunds are not involved. As a result, the committee believes it is appropriate to increase the jurisdictional amount from $100,000 to $200,000 for refund cases which must be reviewed by the Joint Committee while at the same time allowing the Joint Committee to conduct a post-audit review on the handling of tax returns and issues generally by the Internal Revenue Service. This would allow the Joint Committee to examine the administrative effects of the tax laws on a random basis while reviewing tax returns generally.

The committee was made aware that when the Internal Revenue Code was amended in 1969 and 1974 to impose certain taxes on private foundations and pension plans (under chapters 42 and 43), there was no corresponding amendment to require refunds of these taxes to be subject to Joint Committee review. As a result, the committee amendment adds these two areas to those subject to Joint Committee review where the refunds are in excess of $200,000.

Explanation of provision

The committee amendment makes three changes to existing law. First, the jurisdictional amount for Joint Committee refund cases is increased from $100,000 to $200,000. The second amendment authorizes the Chief of Staff of the Joint Committee on Taxation to conduct a post-audit review of tax returns generally. It is contemplated that this review will be done on a random basis in order to provide for a review of issues which may not arise in refund cases, through an examination of returns and other relevant information which deal with these issues. In addition, this is intended to assist the Joint Committee in its oversight responsibilities of the Internal Revenue Service in reviewing the IRS's auditing and other related functions and procedures with respect to the handling of tax returns. Finally, the Joint Committee's refund case jurisdiction is extended to include cases involving refunds (in excess of $200,000) of the tax on private foundations and pension plans imposed under chapters 42 and 43 of the Internal Revenue Code.

The House bill contains no corresponding provisions to these amendments.

Effective date

These amendments will be effective for claims for refund filed, and audits made after December 31, 1976.

Revenue effect

The amendments will have no revenue effect.

11. Use of Social Security Numbers (sec. 1211 of the bill, sec. 6109 of the Code and secs. 205 and 208 of the Social Security Act)

Present law

Under present law, a person required to file an income tax return must include an identifying number in his return (sec. 6109). In general, individuals use their social security numbers for this purpose (regs. sec. 301.6109–1).

The Social Security Act currently provides criminal penalties for the willful, knowing and deceitful use of a social security number for purposes relating to obtaining, or increasing the amount of, benefits under Social Security and certain other programs (sec. 208(g) of the Social Security Act).

Under present law, it is unlawful for any Federal, State or local government agency to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number, except where disclosure is required by Federal statute or is required by a Federal, State or local agency under statute or regulation adopted prior to January 1, 1975.[1]

Reasons for change

Section 6104 of the Code requires taxpayers to use identifying numbers as prescribed by regulations. Although the social security number has in fact been used as the identifying number since that section was enacted in 1961, there is no provision in the Code requiring or specifically authorizing use of the social security number as the identifying number on tax returns. The Secretary of the Treasury has stated that the ability of the IRS to use social security numbers as identifying numbers for tax purposes is essential to Federal tax administration. The committee believes that this provision is necessary to eliminate any question as to the authority of the Secretary to use these numbers.

While the Social Security Act currently provides criminal penalties for the wrongful use of a social security number for the purpose of obtaining or increasing certain benefit payments, including social security benefits, there is no provision in the Code or in the Social Security Act relating to the use of a social security number for purposes unrelated to benefit payments. The committee believes that social security numbers should not be wrongfully used for any purpose.

The Privacy Act of 1974 provides that Federal, State and local agencies may not deny any individual any rights, benefit or privilege provided by law because such individual refuses to disclose his social security number. An exemption is provided for disclosures required by Federal statute or by a statute or regulation adopted before January 1, 1975, in regard to a Federal, State or local agency operating a system of records before that date.

The committee has been told that State and local governments consider the use of social security numbers to be needed as a means of positively identifying taxpayers and as a means of comparing infor-

[1] Section 7(a) of the Privacy Act of 1974, P.L. 93–579.

mation on State income tax returns with Federal tax returns. The adoption of separate State systems of identifying numbers would be costly, duplicative and confusing to taxpayers. The committee believes that State and local governments should have the authority to use social security numbers for identification purposes when they consider it necessary for administrative reasons.

Explanation of provision

The committee amendment amends section 6109 to require that, except as otherwise specified under regulations, an individual shall use his social security number as his identifying number for tax purposes.

The committee amendment also amends section 208(g) of the Social Security Act to make the willful, knowing and deceitful use of a social security number a misdemeanor for all purposes, rather than only for purposes related to benefit payments.

The committee amendment amends section 205(c)(7) of the Social Security Act to establish as the policy of the United States that any State or political subdivision thereof may use social security numbers for the purpose of establishing the identification of individuals affected by any law or program within its jurisdiction. The State or local government may, in addition, require any such individual to furnish his social security number (or numbers; if he has more than one such number) to the State (or its political subdivision). This amendment further provides that, to the extent that any existing provision of Federal law is inconsistent with the policy set forth above, such provision shall be null, void and of no effect.

Effective date

The provisions of this section are effective on the date of enactment.

Revenue effect

This provision has no effect on Federal revenues.

M. TECHNICAL AND MISCELLANEOUS PROVISIONS

1. Tax-Exempt Status of Homeowner Associations (sec. 1301 of the bill and secs. 216 and 528 of the Code)

Present law

In developing a real estate subdivision, a condominium project, or a cooperative housing project, it is common for developers to form owners' associations as an integral part of the overall development. Generally, membership in the association is open only to owners of lots or dwelling units and is normally required as a condition of ownership. These associations are formed to allow individual homeowners, etc., to act together in managing, maintaining, and improving certain areas where they live. The purposes of the organization may include, for example, the administration and enforcement of covenants for preserving the architectural and general appearance of the development, the ownership and management of common areas such as streets, sidewalks, parks, swimming pools, etc., and the exterior maintenance and repair of property owned by its members.

The association is funded by either annual or periodic assessments of the members. Generally, there are two categories of assessments and expenditures made by the association. First, operating assessments are made to acquire, construct, administer, manage, maintain, and operate the areas and facilities common to all residential units. This includes the maintenance of parking areas, hallways, elevators, roofs, exterior of buildings, etc. Second, capital assessments are made to build up reserves for the replacement of equipment and facilities used in common. This includes the equipment and facilities used with respect to swimming pools, tennis courts, clubhouse facilities, etc.

Under present law, generally a homeowners' association may qualify as an organization exempt from federal income tax (under sec. 501 (c)(4) of the Code) only if it meets three requirements (Rev. Rul. 74–99, 1974–1 C.B. 131). First, the homeowners' association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second, it must not conduct activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowners' association owns and maintains must be for the use and enjoyment of the general public.

If an association is unable to meet these three requirements, it will ordinarily be taxed as a corporation. In general, this means that the excess of current receipts over current expenditures at the end of the year would be taxable to it unless the excess is refunded to the members or applied to the subsequent year's assessment. With respect to assessments for capital improvements, if the assessments are designated to be used solely for the purpose of making capital improvements and if the association homeowners have an equity interest in the association, the assessments will not be treated as current income to the association but may be treated as contributions to capital.[1] Also, to the extent that the association's accumulated funds earn income, this income is taxable to the association.

Reasons for change

Most homeowners' associations have found it difficult to meet the three requirements set forth in Rev. Rul. 74–99, discussed above, and therefore, do not qualify for tax exemption. To avoid being taxed on the excess of current receipts over current expenditures, the association must refund such excess to the members or apply the excess to the subsequent year's assessment. In addition, it is not clear that assessments earmarked for major repair and improvements of a member's individual dwelling unit would not be taxable.

Since homeowners' associations generally allow individual homeowners to act together in order to maintain and improve the area in which they live, the committee believes it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity. Consequently, the committee amendment would exempt from income tax any dues and assessments received by a qualified homeowners' association which are paid by property owners who are members of the association, where the assessments are used for the maintenance and improvement of association property. This treatment would be essentially equivalent to the tax treatment of individual homeowners who set aside amounts to maintain and improve their property.

Also, under the committee amendment an association's net investment income, and net trade or business income, is to be taxable, since an individual homeowner would be similarly taxed on investment income, such as interest earned on money set aside for improvements.

Explanation of provisions

Under the committee amendment, a qualified homeowners' association (that is, a condominium management association or a residential real estate association) generally may elect to be treated as a tax-exempt organization. If an election is made, the association is not to be taxed on any "exempt function income".[2] Exempt function income includes membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.[3]

The association is to be taxed, however, on any net income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., would be taxable. Further,

[1] Rev. Rul. 75–370, 1975–2 C.B. 25, indicates that special assessments collected by a nonexempt condominium management association for replacement of the roof and elevators in the condominium are not includible in the association's gross income, and Rev. Rul. 75–371, 1975–2 C.B. 52, indicates that special assessments collected by such an association and accumulated for the replacement of personal property used to maintain common areas are contributions to capital.

[2] If the provisions of the bill are not met (or an election is not made to be treated as tax-exempt), a homeowners' association is to continue to be treated as it is presently treated under existing law.

[3] Assessments for the current management, maintenance and care of association property and also assessments to finance current or future capital improvements to association property are to be exempt from tax.

any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, would be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use would be taxable to the association. Deductions are to be allowed for expenses directly connected with the production of taxable income.

The amendment provides a $100 deduction against taxable income so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not to be allowed, and the special deductions for corporations (such as the dividends received deduction) are not to be allowed.

A homeowners' association is to be taxed as a corporation on its taxable income.[4] The tax rate to be applied is the corporate rate without the surtax exemption. If the association has net long-term capital gain, the capital gain portion of the taxable income is to be taxed at a 30-percent rate.

Generally, two different types of homeowners' associations are treated as tax-exempt under the committee amendment; condominium management associations and residential real estate management associations.

In order to qualify for this treatment under the committee amendment a homeowners' association must meet several common requirements, First, the association must be organized and operated to provide for the management, maintenance, and care of association property. Although the property maintained by the association is generally property owned by the association and available for common use by all the members or property owned by a governmental unit and available for the common benefit of residents of the unit, the association may maintain areas that are privately owned but affect the overall appearance and structure of the project. For example, in a condominium project, the condominium association may enforce covenants with regard to the appearance of the individual units and may maintain the exterior walls and roof of the individual condominium units. Although the property maintained is private, its appearance may directly affect the condition of the entire project. As a consequence, the exterior walls and roofs may be considered as association property which may be maintained by a qualified association. However, for this property to qualify as association property, it is intended that there be a covenant of appearance applying on the same basis to all property in the project, that there be pro rata annual mandatory assessments for maintaining this property on all members of the association, and that membership in the association be compulsorily tied to every person's ownership of property in the project.

Second, a homeowners' association must meet certain income and expenditure tests. Generally, these tests are to insure that the primary activity of the association is to manage, maintain, and improve association property, and and that the owner-members of the associations finance these activities.

[4] Every homeowners' association which elects to be taxed under these provisions and has taxable income is to file an annual return.

Under the committee amendment, at least 60 percent of the association's gross income must consist solely of membership dues, fees, or assessments from owners of residential units or owners of residences or residential lots, as the case may be.

For this purpose, amounts that qualify for the 60-percent test are not to include assessments for capital improvements which otherwise would not be treated as income to the association but would be treated as capital contributions. Qualified income is to include fixed annual membership dues or fees and assessments that vary depending upon the need of the association to pay for acquisition or construction of, and management, maintenance, improvements, real property taxes, etc., on the common property.

Qualifying receipts must be derived from members in the capacity of owner-members and not in the capacity as customers for services provided by the association. For example, payments by owner-members for maid service, secretarial service, cleaning, etc., do not qualify.

Qualified income does not include assessments that are related to particular work done on the privately-owned property of an individual's residence, etc., since this is more in the nature of providing services in the course of a trade or business than in the nature of a common activity undertaken by a collective group of owners. However, pro rata assessments which are paid by all owners in the project and are used for maintaining exterior walls and roofs will be qualified income if the conditions described above for treating this property as association property are met. To the extent that a condominium association or subdivision association owns mortgaged property, assessment to pay principal and interest on the mortgage debt will be qualified income for the 60-percent test.

Amounts received from persons who are not owners of residential property in the project, or who are otherwise not association members, are not includable in the numerator of the fraction used to determine whether the 60-percent income test is met, but are includable in income of the association.

In addition to the income test, the committee amendment provides an expenditure test. Under this test, at least 90 percent of all of the annual expenditures of the homeowners' association must be to acquire, construct, manage, maintain, and care for, or improve, association property. Qualifying expenditures include both current and capital expenditures on association property. For example, qualifying expenditures will include salaries paid to an association manager, secretary and expenses of maintaining association news-letters. Qualifying expenditures will also include expenses for gardening, paving, street signs, security personnel, property taxes assessed on property owned by the association, and current operating expenses of tennis courts, swimming pools, recreation rooms and halls, etc. In addition, expenses for replacement of common buildings, equipment and facilities such as replacement of heating, air conditioning, elevators, etc., will qualify. However, as discussed above, expenditures on privately owned property—as opposed to common property—are to qualify only in the limited situation of repair of exterior walls and roofs where the walls and roofs qualify as association property.

Investments or transfers of funds to be held to meet future costs are not to be taken into account as an expenditure. For example, transfers to a sinking fund account for the replacement of a roof would not qualify as an expenditure for the 90-percent test.

Following existing law with respect to exempt organizations generally, the committee amendment also provides that no part of the net earnings of an exempt homeowners' association may inure to the benefit of any private shareholder or individual. To the extent that members receive a benefit from the general maintenance, etc., of association property, this benefit would not constitute inurement. A rebate to members of excess assessments would generally not constitute inurement. However, if an association pays rebates from its net earnings, such payment will constitute inurement.

In addition to the general requirements, in the case of a condominium management association, substantially all of the dwelling units must be used as residences. Similarly, in the case of a residential real estate management association, substantially all the lots or buildings must be used by individuals for residences.[5]

The committee amendment is essentially the same as the provision in the House bill. However, the committee amendment differs from the House bill in providing that the qualifying expenditures include expenditures for the "acquisition and construction" of association property, such as the acquisition and construction of common property and improvements on common property. The committee amendment also expands the scope of association property to include property owned by a governmental unit for the common benefit of residents of that unit. This is intended to treat as qualifying expenditures funds which the association may expend on roads or common utility facilities which are owned by a governmental unit such as a county or municipal utility district.

The House bill applied the new rules to cooperative housing corporations (as defined in sec. 216(b) (1)), as well as to condominium managements associations and residential real estate management associations.

The committee amendment does not allow cooperative housing corporations to elect to be treated as subject to the new rules, because they have a long history of being treated as taxable organizations. Instead, the committee amendment clarifies present law (sec. 216(c)) to insure that a cooperative housing corporation is entitled to a deduction for depreciation with respect to property it leases to a tenant-stockholder even through such tenant-stockholder may be entitled (under sec. 216(c)) to depreciate his stock in the cooperative housing corporation to the extent such stock is related to a proprietary lease or right of tenancy which is used by the tenant-stockholder in a trade or business or for the production of income. The committee believes that when section 216(c) was added to the Code in 1962, Congress did not intend the allowance for depreciation on such stock to affect the availability to the cooperative housing corporation of depreciation deductions on property leased to tenant-stockholders. However, the Tax Court in one case, *Park Place, Inc.*, 57 T.C. 767 (1972), reached a contrary conclusion, and the committee amendment adds specific

[5] It is intended that if a lot is zoned for residential use it will be treated as being used for residential purposes as long as a nonresidential improvement has not begun on the lot. It is also intended that land uses which are auxiliary to residential use (such as parking spaces. swimming pools. tennis courts, schools, fire stations, libraries. etc.) are to be considered as residential uses.

statutory language to reflect what it believes to be the appropriate interpretation of section 216(c).[6]

The committee does not believe that a clarification of the rules relating to the cooperative housing corporation's ability to take depreciation deductions with respect to property leased to tenant-stockholders will create tax avoidance possibilities because the provisions of existing law (sec. 277) generally prevent nonexempt membership organizations from offsetting nonmember income with losses from dealings with members.

Effective date

The provision applies to payments received after December 31, 1973, in taxable years ending after such date.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

2. Treatment of certain crop disaster payments (sec. 1302 of the bill and sec. 451(d) of the Code)

Present law

Under present law (sec. 451(d)), insurance proceeds received by a taxpayer as a result of destruction or damage to crops may be included in income in the taxable year following the year of their receipt, if it can be established that the income from the crops which were destroyed or damaged would otherwise have been properly included in income in the following taxable year.

Section 451 was amended by the Tax Reform Act of 1969 by adding subsection (d). The reason for this amendment was to avoid the problem of doubling up income for a cash basis farmer by including crop insurance proceeds in income in the taxable year they were received rather than in the taxable year following the year of receipt, which would generally be the pattern of income receipt from sales of crops.

Because of this doubling up of income in the year of receipt, the farmer would have only deductions and no income to report in the next year and therefore would be likely to have a net operating loss to carry back and offset against income in the prior year. However, the farmer in such cases was faced with the payment of tax and subsequent filing for a refund. He also loses the benefit of his personal exemption and his standard or itemized deductions in the year of loss.

Reasons for change

The Agriculture and Consumer Protection Act of 1973 (Public Law 93-86, which amended the Agricultural Act of 1949) provides that specified payments by the Department of Agriculture are to be made to farmers in the event that they are either prevented from planting certain crops because of drought, flood, or other natural disaster or condition or, because of such a disaster or condition, the total quantity of certain planted crops which the farmers are able to harvest on any farm is less than 66⅔ percent of the projected yield of the crop. The

[6] This amendment is not intended to affect the deductibility by a cooperative housing corporation of real estate taxes and interest referred to in section 216(a). See Rev. Rul. 62-178, 1962-2 C.B. 78.

crops covered by these disaster payments are wheat, corn, grain, sorghum, barley, and upland cotton. Premium payments are not required for this protection.

The Service has ruled that the provisions of section 451(d) are not applicable to the payments provided to the farmers who are covered by the Agriculture and Consumer Protection Act of 1973 on the grounds that the proceeds are not insurance proceeds since no premium was paid by the farmer. As a result of the Service's position with respect to the payments received by a taxpayer under the Agriculture and Consumer Protection Act of 1973, these payments must be reported as taxable income in the year of receipt and not in the year in which the income from the sale of the crops would normally be reported.

Explanation of provision

The committee amendment provides that in the case of a taxpayer using the cash receipts and disbursements method of accounting, certain payments received pursuant to the Agricultural Act of 1949, as amended, would be included in the taxable income of the taxpayer, at his election, in the year in which the income normally received from the crops would have been reported. This provision is to apply only to such payments received as a result of (1) destruction or damage to crops caused by drought, flood or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster.

This is the same provision as adopted in the House bill.

Effective date

This provision shall apply to payments received after December 31, 1973, in taxable years ending after such date.

Revenue effect

This provision will reduce budget receipts by $44 million in fiscal year 1977, $42 million in fiscal year 1978, and $42 million in fiscal year 1981.

3. Tax Treatment in the Case of Certain 1972 Disaster Loans (sec. 1303 of the bill)

Present law

Under present law (sec. 165), taxpayers are generally allowed to deduct their losses sustained during the taxable year, including losses attributable to fire, storm and other casualty, to the extent that such losses are not compensated for by insurance or otherwise.[1] In the case of any loss attributable to a major disaster which occurred in an area authorized by the President to receive disaster relief, a special rule allows the loss, at the election of the taxpayer, to be deducted on the return for the year immediately preceding the year of the disaster (that is, the loss may be deducted on the return which is generally filed in the year in which the disaster occurs). In a case where a deduction resulting from a loss is claimed in one year, and compensation is paid with respect to that loss in a later year, the amount of compensation is generally required to be taken into income by the taxpayer under the tax benefit theory.

[1] Individuals generally are allowed to deduct their losses of property (not connected with their trade or business) only to the extent that the loss exceeds $100: losses attributable to an individual's business are fully deductible.

Reasons for change

Certain cases arising in the past have come to the attention of the committee in which individuals who were hard hit by disasters, such as flood, claimed a deduction with respect to the disasters, unaware, in many cases, that they might later receive compensation, or partial compensation, for their loss. In some instances, the compensation may be received in a year for which the taxpayer is in a higher tax bracket than he was in for the year for which the disaster loss deduction was claimed. As a result, the taxpayer may be required to pay more tax, with respect to the compensation or reimbursement, than would have been owing if he had not claimed the deduction in the first place.

Explanation of provision

The committee amendment provides that, under certain circumstances, in the case of a loss attributable to a disaster which occurred in 1972, in an area designated by the President as a disaster relief area, the tax on the first $5,000 of compensation received with respect to that loss is not to exceed the tax which would have been payable if the $5,000 (or lesser) deduction had not been claimed. This treatment applies only if the taxpayer elects to come under these provisions, in a time and manner to be prescribed in regulations, and is subject to certain conditions.

In order for the taxpayer to elect the benefits of this provision, he must have suffered a disaster loss for the year 1972, and to be fully eligible under this provision his adjusted gross income for the year in which he claimed the disaster loss as a deduction (either 1972 or 1971, as the case may be) cannot have exceeded $15,000 ($7,500 in the case of a married individual filing a separate return). In those cases where an individual who is otherwise eligible under this provision has adjusted gross income in excess of $15,000 (or $7,500, whichever applies), the $5,000 limit is to be reduced dollar-for-dollar to the extent his adjusted gross income exceeds $15,000.

The election may be made with respect to up to $5,000 of compensation which is paid in a year after the year for which the loss deduction is claimed and which results either (1) from the forgiveness or cancellation of a disaster loan under section 7 of the Small Business Act or an emergency loan under subtitle C of the Consolidated Farm and Rural Development Act, or (2) from a payment made to the taxpayer in settlement of a tort claim which the taxpayer had against another person.

Any compensation or reimbursement in excess of the $5,000 limitation must be taken into income by the taxpayer for the year in which the payment is received.

If these conditions are satisfied, and the taxpayer makes the election, as provided for under the amendment, then the tax with respect to the compensation or reimbursement is not to exceed the tax which would have been payable if the loss had not been claimed as a deduction for 1971 or 1972 (as the case may be). For example, if a $5,000 deduction was claimed for 1972 which had the effect of reducing the taxpayer's taxable income for that year to $5,000, and the taxpayer was a married taxpayer who filed a joint return for that year, the tax liability with respect to $5,000 of compensation received in a later year from disaster loan forgiveness or settlement of tort claim liability is not to exceed the marginal rate on the difference between $5,000 and $10,000 of taxable income.

In addition, since many of the taxpayers affected by this provision may still be suffering hardships from the effects of the flood, the committee amendment provides that any tax with respect to this $5,000 amount which was still unpaid on October 1, 1975, may be paid in three equal annual installments, with the first such installment due and payable on April 16, 1977. Also, under the amendment, no interest on any deficiency with respect to this $5,000 amount is to be payable for any period prior to April 15, 1977, and no interest is to be payable with respect to any installment payment (made under the rule as just outlined) before the due date for that installment.

The provisions of the committee amendment are generally the same as those of the House bill (except that under the House bill the first installment payment of tax would have been due on April 15, 1976).

Effective date

This provision shall apply to payments received after December 31, 1973, in taxable years ending after such date.

Revenue effect

This provision will reduce budget receipts by $15 million in fiscal year 1977, $15 million in fiscal year 1978, and less than $5 million in fiscal year 1981.

4. Tax Treatment of Certain Debts Owed by Political Parties to Accrual Basis Taxpayers (sec. 1304 of the bill and sec. 271 of the Code)

Present Law

Under present law, any deduction generally allowable for bad debts (sec. 166) or for worthless securities (sec. 165(g)) is not allowed for a worthless debt owned by a political party. This provision applies to all taxpayers other than a bank (as defined in sec. 581), but where the debt arises out of the sale of goods or services, the provision affects only taxpayers utilizing the accrual method of accounting (because these taxpayers would have taken into income the receipts which give rise to the debt).

The provision in present law defines political parties to include all committees of a political party and all committees, associations, or other organizations which accept contributions or make expenditures on behalf of any individual in any Federal, State or local election.

Reasons for change

The disallowance of a bad debt deduction for debts owed by political parties causes a substantial hardship for taxpayers who are in the business of providing goods or services (such as polling, media, or organizational services) to political campaigns and candidates. The business of providing these types of services has grown substantially in recent years. As a result, a significant number of taxpayers have been placed in a less favorable position than taxpayers in virtually any other business because they are not able to deduct bad debts which arise in the ordinary course of their business.

The provision disallowing any bad debt deduction was originally enacted to prevent tax deductions for concealed campaign contributions. However, since, in the case of the sale of goods or services, the deduction is allowed only if the amount of gross receipts which gave rise to the debt has been included in taxable income, the effect of the provision is to tax these individuals on income which they have never received.

Furthermore, since present law does not affect cash basis taxpayers who sell services for political campaigns because in that case no amount is taken into income, the provision discriminates against taxpayers whose business differs from others only in that they are on the accrual method of accounting.

Explanation of provision

The committee amendment adds an exception to the provision disallowing a deduction for bad debts owed by political parties (sec. 271). The exception applies only to taxpayers who use the accrual method of accounting. These taxpayers are to be allowed a bad debt deduction with respect to debts which are accrued as a receivable in a *bona fide* sale of goods or services in the ordinary course of their trade or business. Thus, the receipts giving rise to the debt must have been taken into income in order for the deduction to be obtained.

The amendment limits this exception to those cases in which 30 percent of all of the receivables accrued in the ordinary course of all of the trades or businesses of the taxpayer are due from political parties. Thus, the exception is limited to those taxpayers whose sales to political parties (including political campaigns and candidates) constitute a major portion of their trades or businesses. In determining the amount required to meet the 30 percent rule, all of the taxpayer's trades and businesses are to be considered. Thus, in the case of an individual, every trade or business which the taxpayer controls is to be aggregated for purposes of this test. In the case of a taxpayer which is a corporation, every trade and business of all corporations under common ownership with the taxpayer is to be aggregated.

The bad debt deduction is to be allowed only if the taxpayer has made substantial continuing efforts to collect on the debt. Thus, a taxpayer must make good faith efforts over a period of time to collect the debt and must be able to document those efforts. However, it is not intended that a taxpayer is required in any case to file a lawsuit against the debtor in order to be determined to have made substantial continuing efforts.

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

It is anticipated that this provision will produce a negligible loss of revenues.

5. Prepublication Expenses (sec. 1305 of the bill and secs. 61, 162, 174, 263 and 471 of the Code)

Present law

Present law (sec. 174(a)(1)) permits, under certain circumstances, an itemized deduction for research and experimental expenditures otherwise chargeable to a taxpayer's capital account. The regulations under this provision define research and experimental expenditures as expenditures incurred in connection with a taxpayer's trade or business which represents research and development costs in the experimental or laboratory sense. The regulations specifically exclude expenditures for research in connection with literary, historical, or similar projects.

In Rev. Rul. 73–395,[1] the Internal Revenue Service held that the costs incurred by an accrual basis taxpayer in the writing, editing, design and art work directly attributable to the development of textbooks and visual aids do not constitute research and experimental expenditures under section 174. The Service further held that these costs cannot be inventoried (under sec. 471) but instead represent expenditures that must be capitalized (under sec. 263) and may be depreciated (under sec. 167(a)).

However, the ruling also stated that expenditures incurred in the actual printing and publishing of textbooks and visual aids should be inventoried (under sec. 471) with a part of the costs being apportioned to be books and visual aids still on hand at the end of the taxable year. Also, expenditures for manuscripts and visual aids that are abandoned may be deductible as losses (under sec. 165).

On March 17, 1976, the Internal Revenue Service announced[2] that it had begun a study project as a result of questions regarding the application of Rev. Rul. 73–395 to certain prepublication expenses of the publishing industry. The Service will study the application of sections 162 (dealing with the deduction of trade or business expenses), 263 (treatment of capital, expenditures), and 471 (general rule for inventories) to prepublication costs within different segments of the industry.

The Service stated that the application of these sections is not adequately explained in Rev. Rul. 73–395, and that the project is expected to result in the publication of regulations and/or additional revenue rulings. It is also likely that Rev. Rul. 73–395 will be modified and clarified or superseded.

Pending completion of this project, the Service is suspending audit and appellate activity with respect to cases in which the deductibility of these prepublication expenses of publishers is an issue. No further action will be taken in these cases except as necessary to protect the interest of the Government.

In the case of authors, the Internal Revenue Service requires capitalization (under sec. 263) of prepublication travel and research expenditures incurred while researching, writing, and arranging material for a book. These expenditures are treated as capital items because they do not qualify as deductible research and experimental expenditures under the regulations for section 174 and because the Service considers

[1] 1973–2 C.B. 87.
[2] Press Release IR–1575.

them amounts expended for securing a copyright which must be capitalized under the regulations for section 263.

Under section 167, these expenditures may be depreciated over their useful lives. If the actual useful life of a copyrighted work can be estimated, that period is used for determining the depreciation rate. Otherwise the 28-year copyright term is used.

A decision of the United States District Court, Central District, California,[3] however, held that a taxpayer, found to be in the business of writing, could deduct as ordinary and necessary business expenses (under section 162(a)) the expenses incurred for meals, lodging and travel while researching, writing, and arranging material for a book. The court explicitly held that the writer's expenditures were not expenses incurred for the production of a book by one not in the trade or business of writing; nor were they expenses incurred for securing a copyright. In Rev. Rul 73–395, the Service announced that it would not follow this judicial decision.[4]

Reasons for change

The committee has been made aware of the concerns of the publishing industry as to whether Rev. Rul. 73–395, as described above, correctly interprets present law under sections 61, 162, 174, 263 and 471 as they apply to the publishing industry. The committee understands that historically tax accounting practices in the publishing industry have varied greatly and no standard procedures have been developed. Industry members apparently have followed their own interpretations, particularly with regard to the treatment of publishers' prepublication expenditures. The committee further understands that in the case of these expenses, some publishers have deducted them currently while other publishers have capitalized them. The committee believes that in view of the uncertainty with respect to the treatment of prepublication expenditures, the Internal Revenue Service should review this treatment and issue regulations to establish a uniform treatment of such expenditures for the entire publishing industry. This would allow interested taxpayers to have the opportunity to advise the Service about the practices and problems within the industry with respect to this matter. Since the committee is concerned about the retroactive application of Rev. Rul. 73–395 which would affect practices consistently followed by many taxpayers for years, the committee believes that any new rules applicable under regulations promulgated after the enactment of this bill should only have prospective application. The committee believes that the Service's position to disallow any deductions for authors' prepublication expenses and its decision not to follow the ruling in *Stern* v. *United States* results in inequitable treatment for taxpavers who are professional authors engaged in the business of writing. The committee believes authors should be allowed to deduct as business expenses the essential, reasonable costs of earning income from their writing. Furthermore, the committee believes

[3] *Stern* v. *United States*, 1971–1, U.S.T.C. 9375. The case involved two issues: (1) whether the taxpayer was engaged in the business of writing, and (2) whether traveling expenses were deductible as ordinary and necessary business expenses or constituted non-deductible expenditures for the improvement of a capital asset.

[4] The Government said that it did not appeal the case because it had erroneously stipulated to the effect that "if the taxpayer was determined to be in the business of being a writer, the traveling expenses in question were ordinary and necessary."

that it would be discriminatory to allow publishers to deduct expenses which authors must capitalize. Therefore, the committee believes it appropriate to provide relief from Revenue Ruling 73–395 to authors, as well as to publishers.

Explanation of provision

The committee amendment generally allows publishers and authors to continue their customary treatment of prepublication expenditures without regard to Rev. Rul. 83–395 and provides for new regulations. The committee amendment is substantially the same as the provision in the House bill, except that it extends its application to authors.

The prepublication expenditures affected by the committee amendment are those paid or incurred in connection with the taxpayer's trade or business of publishing or writing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid, or similar product.

The committee amendment allows taxpayers to treat their prepublication expenditures in the manner in which they have been applied consistently by the taxpayer in the past until new regulations are issued with regard to these expenditures after the date of enactment of the bill.

Any regulations issued by the Internal Revenue Service would apply only to taxable years beginning after their issurance. Until these regulations are issued, the Internal Revenue Service would administer the application of sections 61, (as it relates to cost of goods sold) 162, 174, 263 and 471 to the prepublication expenditures of both publishers and authors without regard to Rev. Rul. 73–395. In addition, as indicated above, the Service would administer these sections in the same manner as they were consistently applied by taxpayers prior to the issuance of Rev. Rul. 73–395. If a taxpayer did not consistently follow a specific tax accounting method, his returns would be treated by the Service in accord with usual administrative procedures.

Effective date

Any regulations issued by the Service on publishers' or authors' prepublication expenditures after the date of enactment will apply prospectively only to taxable years beginning after their issuance.

Revenue effect

The committee amendment will have little or no revenue effect because it allows taxpayers to continue their customary tax accounting practice until such time as any new regulations require prospective changes.

6. Exemption From Taxation of Interest on Bonds Issued to Finance Certain Student Loans (Sec. 1306 of the Bill and sec. 103 of the Code)

Present law

Under present law (sec. 103(a)) interest paid on certain governmental obligations is exempt from Federal income tax. These obligations are, in general, those of the States and their political subdivisions, and of certain corporations organized under an Act of Congress as instrumentalities of the United States. However, interest on such governmental obligations (with a minor exception) is not exempt from taxation if a major portion of the proceeds can be reasonably expected to be used, directly or indirectly, to purchase nonexempt securities or obligations that can reasonably be expected to produce a higher yield over the term of the issue than the yield on the governmental obligations. These governmental obligations, which are subject to Federal taxation "arbitrage bonds." In addition, governmental obligations whose proceeds are expected to be used to replace such nonexempt governmental obligations are themselves subject to tax.

Governmental obligations are not treated as arbitrage bonds merely because their proceeds are temporarily invested in obligations paying a higher yield until those proceeds can be put to their intended purpose. In addition, obligations are not arbitrage bonds simply because their proceeds are invested in obligations paying a higher yield that are a part of a reasonably required reserve or replacement fund.

Reasons for change

The committee is aware that groups in at least one State are attempting to develop a student loan program for students desiring a college education. Since political subdivisions in the State apparently do not have the governmental authority to issue bonds to finance their own student loan programs, not-for-profit corporations in that State are being organized to finance the needed student loan programs. These corporations, however, face considerable obstacles because the interest on bonds they wish to issue to finance student loans will be taxable under present law. The corporations are not political subdivisions of the State and cannot be treated under the Treasury regulations as acting "on behalf of" the State or its political subdivisions. Even if they were described in section 103(a), these obligations might not be exempt because they would be arbitrage bonds in the sense of section 103(d).

Under the Emergency Insured Student Loan Act of 1969, 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 could be higher than the maximum yield the corporations believe they will be able to pay on their bonds if they are to cover administrative expenses and maintain a solvent loan program. Consequently, their bonds would be considered arbitrage bonds and not entitled to tax exemption under present law.

The committee believes it is appropriate to treat the obligations of these corporations providing student loans in the same manner as if the State had issued the bonds directly.

As indicated previously, only one State, Texas, has been called to the committee's attention in which this situation exists. However, similar problems, which may exist in other States, could benefit from the committee amendment.

Explanation of provision

The committee amendment adds to the list of exempt obligations described in section 103(a) those obligations of nonprofit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the political subdivision, or be required to be used to purchase additional student loan notes. The obligations are to be called "Qualified Scholarship Funding Bonds."

As a result of this provision, organizations which wish to maintain student loan programs will have statutory authority to issue tax-exempt bonds to finance their operations.

In addition, section 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, bonds issued to finance student loan programs would be expected to be able to avoid arbitrage bond classification.

No comparable provision is contained in the House bill.

Effective date

These amendments would apply to obligations issued on or after the date of enactment. Thus, the interest on bonds issued on or after the date of enactment in order to finance student loan programs to enable students to attend institutions of higher learning may be exempt from Federal taxation if the requirements of the amendment are met.

Revenue effect

It is estimated the amendments made by this provision will reduce the revenues by less than $5 million annually.

7. Treatment of Face-Amount Certificates (sec. 1307 of the bill and sec. 1232 of the Code)

Present law

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

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

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

On November 26, 1975, I.S.A. filed an action in the U.S. District Court for the District of Columbia for a declaratory judgment that these regulations, relating to face-amount certificates, be declared invalid. On December 26, 1975, the Court dismissed the action for the declaratory judgment. In its opinion, the Court concluded that the government has a "substantial basis" for promulgating these regulations.

On December 23, 1975, an action seeking a temporary restraining order and a preliminary injunction to enjoin the enforcement of these regulations was filed by Huntoon Paige & Company, Inc., and Association for Investment in United States Guaranteed Assets, Inc., in the U.S. District Court for the Southern District of New York. On December 30, 1975, the Court denied the plaintiff's request and dismissed the action.

Reasons for change

The Tax Reform Act of 1969 amended the provisions relating to the treatment of original issue discount (sec. 1232) to require the ratable inclusion of such discount in the case of bonds and other evidences of indebtedness. However, at the time of this amendment, Congress did not specifically address the question as to whether face-amount certificates were subject to these new provisions or were to be taxed as annuities under section 72. In reviewing this matter, the committee believes that the amount of any discount should be included in the taxpayer's

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

gross income only at the time of sale, exchange or other disposition of the certificate (or redemption by the issuer).

Explanation of provision

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

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

The provisions apply to a face-amount certificate as defined in section 2(a)(15) of the Investment Company Act of 1940.

Effective date

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

Revenue effect

It is estimated that enactment of this provision will reduce budget receipts by less than $5 million.

8. Income From Lease of Intangible Property as Personal Holding Company Income (Sec. 1308 of the Bill and Sec. 543 of the Code)

Present law

Under present law, a corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and at least 60 percent of the corporation's adjusted ordinary gross income comes from certain types of income.

In general, rental income is treated as personal holding company income unless such rent comprises 50 percent or more of the corporation's adjusted ordinary gross income and, if the company has a substantial amount of other types of personal holding company income, it distributes such income (sec. 543(a)(2)).

Under present law, amounts which a corporation receives from renting or leasing tangible corporate property to a 25 percent or larger shareholder are treated as personal holding income, but only if the corporation derives over 10 percent of its total income from other types of personal holding company income (sec. 543(a)(6)). The Internal Revenue Service has published a revenue ruling holding that amounts which a corporation receives for leasing intangible property (such as a license to use or distribute a secret process or trade brand) to such a shareholder are to be treated as ordinary royalty income and not as income tested under section 543(a)(6) (Rev. Rul. 71-596). Consequently, the full amount of the license payments becomes personal holding company income in the category of "royalties" (sec. 543(a)(1)), regardless of how much income of other types the corporation may have. The income tax regulations take the position that "royalties" include amounts received for the privilege of using secret processes and formulas, good will, trademarks, trade brands, franchises and other like property and that this category does not include rents (regulations section 1.543-1(b)(3)).

Reasons for change

Broadly stated, the rationale for the present treatment of rental income under the personal holding company rules is that, if the rents received for the use of corporate property are over half of the corporation's total income, the corporation is engaged in operating an active real estate business and generally ought not be treated as being used merely to deflect passive income away from its shareholders. Similarly, rental or lease income received from shareholders has generally not been treated as an abuse unless the income is used to shelter appreciable amounts of other investment income. It has come to the committee's attention that in some situations a corporation may be given ownership of licenses and other intangible property in order to protect the license by reason of the perpetual life of the corporation. However, often the individual shareholders still desire to conduct a trade or business in which the license is used or needed. Therefore, the corporation will license the contract right to one or more of its shareholders who will use the contract right in conducting their own active business. In this tvpe of situation, it is argued, the corporation is not being used as an "incorporated pocketbook." The committee believes that if intangible property is licensed to a shareholder and used in an active trade or business, the corporation's income is closer to a rental situation and should be governed by the rule relating to use of tangible property bv a shareholder rather than bv the rule for ordinary royalties. In other words, amounts received from a 25 percent or greater shareholder should be personal holding company income only if over 10 percent of the corporation's total income is derived from other personal holding company income sources.

Explanation of provision

The committee amendment provides that amounts received under a lease of intangible personal property to a 25 percent or greater shareholder are to be governed by the rule that now applies to a corporate lease of tangible property to such a shareholder. There is no compaable provision in the House bill.

Under the amendment, amounts which a corporation receives under a lease of intangible personal property to a 25 percent or greater shareholder are to be governed bv the present rule for compensation received for the use of corporate property by a shareholder. Under this rule, the full amount received bv the corporation for the shareholder's use of such property is not automatically treated as personal holding company income. Whether such income is treated as personal holding company income depends on whether the corporation derives more than 10 percent of its total income from other personal holding company sources.

The amendment imposes a limitation, however, so that payments received from a lease of intangible property to a shareholder are to be tested under section 543(a)(6) only if the intangible assets are part of an integral group of assets consisting of tangible and intangible assets which the shareholder uses in actively carrying on his trade or business. If the shareholder does not use the license or other intangible asset (along with tangible assets) in carrying on his business, the license payments received by the corporation are to be treated as ordinary royalties governed by the present rules of section 543(a)(1) or, if appropriate on the facts, under other rules relating to mineral, oil or gas royalties (sec. 543(a)(3)) or copyright royalties (sec. 543(a)(4)).

Under present law, the property leased or licensed from the corporation must be used by the "individual" who owns 25 percent or more of the stock. The committee believes that this requirement should be considered satisfied if the property is in fact used by a partnership in which the individual (who is a 25 percent or greater shareholder) is a partner or in which a trust is a partner. In determining ownership of the corporation's stock, however, for purposes of the 25-percent stock ownership requirement of section 543(a)(6), the constructive ownership rules in section 544 will continue to apply.

Effective date

The amendment to the general rule of section 543(a)(6) relating to intangible property is effective for corporate taxable years ending after December 31, 1964.

Revenue effect

It is estimated that this provision will not have a significant effect on tax revenues.

9. Work Incentive (WIN) and Federal Welfare Recipient Employment Incentive Tax Credits (sec. 1309 of the bill and sec. 50 (A) of the Code)

Present law

Under present law, a work incentive (WIN) credit equal to 20 percent of the wages paid during the first 12 months of employment to qualified AFDC recipients is available to employers engaged in a trade or business who hire such employees. Qualified participants are certified by the local WIN agency.

The amount of the credit available in any year is limited to the first $25,000 of tax plus one-half of tax liability in excess of $25,000. The credit is not available in the case of an employee who ceases to work for the original employer unless the employee voluntarily quits, becomes disabled, or is fired for misconduct.

Under the Federal welfare recipient employment incentive tax credit (welfare recipient tax credit), all private employers including those who provide employment for private household workers are eligible for the credit. Qualified employees are AFDC recipients who have received benefits for 90 days. The credit is essentially the same as the WIN credit: 20 percent of eligible wages, except that there is a limit of $5,000 a year on the annual eligible wages for nonbusiness employees; the same overall credit limit of $25,000 of tax plus one-half of the excess also applies. The State or local welfare agency certifies recipients as qualified. This provision expires on July 1, 1976.

Reasons for change

WIN tax credit.—The committee is concerned that the WIN tax credit is not being used to the extent anticipated. One aspect of the WIN tax credit which has been cited as a major reason why employers are not using the credit is the requirement for repayment of the credit by the employer if he terminates the employment without cause before the end of the second year. A significant percentage of the amounts which have been earned as tax credits have reportedly been recovered by the IRS for this reason. It has been suggested to the committee that the removal or modification of this recapture provision would encourage greater use of the tax credit and would make it consistent with the welfare recipient tax credit, which has no recapture provision.

Another suggestion for promoting greater use of the credit has been to raise the dollar limitations on the amount which any single employer can claim. Treasury statistics indicate that about 63 percent of the amount claimed for WIN is by corporations with assets in excess of $250 million. These larger corporations might be expected to make greater use of the credit by hiring more welfare recipients if there were a higher limit on the amount which could be claimed.

Welfare recipient tax credit.—The welfare tax credit, which is due to expire July 1, 1976, has been in effect for too brief a time to judge its effectiveness. Early statistics show, however, that there has been virtually no use made of the provision thus far. Part of the problem is that it is still unknown and employers have not yet had any experience with it. In order to give it a fairer test, it would seem to be desirable to extend the expiration date into the future. This would assure not only that there would be sufficient opportunity to make employers aware of its adavntages, but also that it could be tested over time for its usefulness as a means of getting welfare recipients moved into jobs.

Because the welfare tax credit was originally passed with a 15-month limit, there was no reason to provide for a limit to the period of time for which the credit could be claimed for any one employee. However, if the credit is extended for several years such a limit might be considered. It is difficult to justify giving an employer a tax advantage for an indefinite period into the future for each welfare recipient he may hire. One year would seem to be adequate time for the employer-employee relationship to have become well enough established to make termination of the credit with regard to an employee justifiable and without undue risk to the employee. This would be consistent with the WIN tax credit provision which also gives a credit only for the first 12 months of employment.

Explanation of provision

The committee amendment makes several modifications to both the WIN and welfare tax credits to make them more effective. The House bill has no comparable provisions.

The committee amendment makes three changes in the WIN credit. First, the credit is available from the date of hiring if employment is not terminated without cause before the end of six months. Second, an additional exemption is added to the recapture rules so that there would be no recapture of the credit if the employee were laid off due to lack of business. Third, the limit on the credit is doubled from $25,000 to $50,000 plus one-half of the excess over $50,000.

The committee amendment also made three changes in the welfare recipient tax credit. First, the expiration date is extended from July 1, 1976, to January 1, 1981. Second, a limit of 12 months for which the wages of any one employee would be eligible for the credit is provided. Third, the WIN agencies could also certify eligibility for the welfare recipient tax credit.

Effective date

These changes are to be effective upon the date of enactment of this Act.

Revenue effect

This provision will reduce budget receipts by $3 million in fiscal year 1977, $7 million in fiscal year 1978, and $17 million in fiscal year 1981.

10. Excise Tax on Parts for Light-Duty Trucks (sec. 1310 of the bill and sec. 6416(b)(2) of the Code)

Present law

The Revenue Act of 1971 repealed the 10-percent excise tax on light-duty trucks and buses (those with gross vehicle weight of 10,000 pounds or less). As a result, truck and bus parts and accessories sold by the vehicle manufacturer as part of (or in connection with the sale thereof) a light-duty truck or bus are not subject to tax—neither the 10-percent tax that used to be imposed on the vehicle, nor the 8-percent tax on truck parts and accessories. Also, if a truck parts or accessories manufacturer sells parts or accessories to a manufacturer of light-duty trucks for use in "further manufacture" of those trucks, the parts and accessories are not subject to tax. However, if the truck parts manufacturer sells parts separate from the light-duty trucks and the installation of those parts by a retail truck dealer technically is not "further manufacture" of the trucks, then the manufacturer's excise tax of 8 percent applies. This is so even though the part or accessory is sold to the retail customer at the same time he purchases the tax-exempt light-duty truck or bus.

Reasons for change

It appeared inequitable to the committee to tax a truck part or accessory when purchased by a truck dealer as a separate item where it is sold on or in connection with the retail sale of a light-duty truck, while exempting such parts or accessories if they were included with the truck as delivered from the manufacturer to the dealer. The committee amendment removes the discriminatory treatment of such parts and accessories.

Explanation of provision

The committee amendment (to sec. 6416(b)(2)) provides that the 8-percent manufacturer's excise tax on truck parts and accessories is to be refunded or credited to the manufacturer in the case of any part or accessory sold on or in connection with the first retail sale of a light-duty truck. Thus, those parts and accessories are to be effectively treated the same as the parts and accessories that actually are a part of the tax-exempt truck as delivered from the manufacturer. The credit or refund is not intended to cover replacement parts even if ordered at the time of the purchase of the truck, but only those parts and accessories which are to have original use on the purchased truck.

The House bill contains no comparable provision.

Effective date

The amendments made by this section apply to parts and accessories sold on or after July 1, 1976.

Revenue effect

This amendment is estimated to result in annual revenue losses of about $3 million. This revenue would otherwise go into the Highway Trust Fund (through September 30, 1979).

11. Certain Franchise Transfers (sec. 1411 of the bill and secs. 751 and 1253 of the Code)

Present law

Section 1253, which was added to the Internal Revenue Code by the Tax Reform Act of 1969, provides generally that the transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

Gain which would be treated as ordinary income pursuant to section 1253 (unlike gain which would be treated as ordinary income under any other sections of the Code, e.g., sections 1245, 1250, 1251, and 1252), is not treated as an "unrealized receivable" of a partnership which would have the effect of causing ordinary income upon certain partnership distributions, payments in liquidation of a partnership interest, or sales of other dispositions of partnership interests.

Section 1253 applies to all transfers taking place after December 31, 1969. Unlike certain other provisions of the 1969 Act, no exception was made for transfers occurring after December 31, 1969, pursuant to contracts which were in effect prior to that date.

Reasons for change

The committee believes that partnership transactions of the type described above should, in situations where a franchise, trademark or trade name is involved, be subject to ordinary income treatment pursuant to section 1253 in cases in which, if a partnership were not involved, ordinary income would be recognized. In general, failure to deal with partnership transactions in this manner may allow taxpayers to avoid ordinary income treatment under section 1253 by restructuring transactions to involve the formation of a partnership by the franchisor and the franchisee followed by a sale or liquidation of the franchisor's partnership interest without the application of section 1253 to the proceeds received by him.

It has come to the committee's attention that the failure to have an exception to the section 1253 rules for post-1969 transfers which are being made pursuant to contracts entered into prior to January 1, 1970, has resulted in hardship to certain taxpayers, particularly in situations where a professional practice is involved and the transfer is to be made to a person who is an employee or partner of the transferor.

Explanation of provision

The committee amendment provides that, with respect to certain partnership distributions, sales of partnership interests, and distributions in liquidation of partnership interests, the term "unrealized receivable" is to include the ordinary income element which would have been recognized had the partnership transferred a franchise, trademark, or trade name.

The committee amendment also provides special transitional rules which provide that section 1253 will not apply to a transfer of a franchise, trademark or trade name if (1) the transfer is pursuant to a contract that was in existence prior to January 1, 1970, (2) the contract relates to a trade or business in which a professional practice is involved, and (3) the transfer is made to a person who immediately before the transfer is an employee or partner of the transferor. This rule is intended to allow certain owners of professional practices who, prior to 1970, had made arrangements to transfer their practices to employees or partners not to have the provisions of section 1253 apply to such transfers. However, in determining whether the transferor is entitled to capital gain treatment on such a transfer, the transfer will be subject to the ordinary rules of law relating to whether there had been a "sale or exchange" of a "capital asset". This new transitional rule is to apply in cases where there is a contract to transfer in existence on January 1, 1970, whether or not such contract is binding on the parties at such time. The transitional rules are also to apply only where a professional practice is involved. However, where a professional practice is involved and there is a related business which is transferred at the same time as part of the same agreement, such a transfer will be covered by the transitional rule. Thus, for example, an optician's business would be directly related to an optometrist's business carried on in the same premises, and a transfer of both businesses would, if the other requirements of the rule are satisfied, not be subject to section 1253.

This transition rule is further limited by the requirement that the transfer must be made to a person who, immediately before the transfer, is an employee or partner of the transferor. Generally, this requirement is designed to limit the transitional rule to situations where the transferor and the transferee have had an ongoing relationship prior to January 1, 1970, and such ongoing relationship had, in part, been carried on in the assumption that the transferee was to be able to acquire the business over a period of time or at some time in the future.

There is no comparable provision in the House bill.

Effective date

The amendment to the partnership provisions (sec. 751(c)) is to apply to transactions occurring after December 31, 1976, in taxable years ending after that date. The transitional rules for section 1253 are to apply to transfers made after December 31, 1969, subject to the conditions specified above.

Revenue estimates

It is estimated that this provision will have no significant revenue effect in fiscal year 1977 and future years.

12. Clarification of an Employer's Duty to Keep Records and to Report Tips (sec. 1312 of the bill and secs. 6001 and 6051 of the Code)

Present law

There has been some dispute regarding an employer's duty to report to the Internal Revenue Service charge account tips received by his employee (for example, a waiter or waitress) but not included in the monthly total tip amount usually reported by the employee to the employer. However, under Revenue Ruling 76–231, released May 26, 1976, the Service announced that employers are to be required to report such charge account tips.

Present law (sec. 6053(a) of the code) requires employees to report all tips received (including charge account tips) to their employers, usually on a monthly basis. The tips required to be reported to employers are tips received and retained after any tip-splitting (such as by waiters and waitresses with busboys) or tip-pooling (such as by a waiter with other waiters.) Section 6051(a) requires employers to report on IRS Forms (W–2) as wages subject to income tax withholding and Federal Insurance Contributions Act (FICA) withholding only the tips actually reported to them by their employees pursuant to section 6053(a).

Section 6041(a) requires every employer of an employee earning $600 or more yearly to report the total of that employee's earnings to the IRS. As a result, the regulations (sec. 1.6041–2(a)(1)) specify that earnings in addition to those required to be reported as subject to withholding are required to be reported separately to the IRS on the Form W–2 for the employee. As stated above, Revenue Ruling 76–231 has recently held that this means that charge account tips not reported to the employer by the employee must nevertheless be reported to the the IRS by the employer. If, because of tip-splitting or tip pooling, the amount reported by the employee on his income tax return differs from the total amount of tips reported by the employer for that employee, the employee is required by the ruling to attach an explanation of the difference to his income tax return.

Reasons for change

The requirement that employers report to the IRS charge account tips not reported to them by their employees appears to entail burdensome record-keeping requirements for many employers. As a matter of general practice, charge account tickets are turned over by, for example, a waiter to the business manager, who then, or shortly thereafter, reimburses the waiter from the cash register or other ready cash for the amount shown on the charge ticket which represents the waiter's tip. However, at the end of an accounting period, employers may have only a record of total charge account tips, and do not necessarily have any way of breaking down that total per employee. In order to determine the amount of charge account tips received by each employee, such employers must go back to allocate each charge ticket to the employee responsible for it, if that employee's identity is identifiable from the charge ticket.

The committee believes that the practices presently followed by employers in reporting their employees' tips to the Service is appropriate and that the new rules proposed by the Service present an unnecessary complication for employers. The committee provision nullifies the recent IRS ruling relating to charge tips.

Explanation of provision

The committee amendment specifies that the only employer tips which an employer must report are the tips reported to the employer by the employee under present law (sec. 6053(a)). Accordingly, employers would not be required by law to keep accounts of employees' charge ticket tips or to report those tips to the IRS even if some of those tips are not reported to the employer by the employee. This clarification is accomplished through an amendment to section 6051(d) of the Code.

The committee amendment also clarifies the employer's record-keeping requirements .Section 6001 is amended to provide that the only records an employer must keep in connection with charge tips are charge receipts and copies of tip reporting statements furnished to employers by employees pursuant to section 6053(a). Thus, employers would not be required to maintain running tabulations of the allocation of total charge account tips to particular employees.

Effective date

The committee provision is effective as to calendar years beginning after December 31, 1976. The portions of Revenue Ruling 76–231 relating to charge tips which were not reported by the employee to the employer applied only to calendar years beginning after December 31, 1976. As a result, only Forms W–2 for calendar years beginning after 1976 had to include charge tips that were not reported to the employer by the employee. Therefore, providing an effective date for the committee's amendment which is identical to the effective date of the revenue ruling will nullify any obligation of employers caused by the revenue ruling to report to the IRS charge account tips that were not reported to them by their employees.

Revenue effect

It is estimated that this provision will result in reduced tax receipts of less than $5 million.

13. Treatment of Certain Pollution Control Facilities (sec. 1313 of the bill and secs. 48 and 169 of the Code)

Present law

Five-year amortization was available to a taxpayer at his election for pollution control equipment that was placed in service in 1969 and continued to be available for equipment placed in service before January 1, 1976, when the provision expired. The provision was made available as a special incentive for pollution control equipment in the Tax Reform Act of 1969, because the Act also repealed the investment credit.

Rapid amortization was available for the installation of certified pollution control equipment with a useful life of up to 15 years. For equipment with a useful life greater than 15 years, the basis attributable to the first 15 years could be amortized over a 5-year period, and the remaining years could be depreciated under the regular rules for depreciation, including use of the various methods of accelerated depreciation. The adjusted basis of the property that was eligible for rapid amortization was not made eligible for the investment credit when it was re-enacted in 1971.

In order to be eligible for rapid amortization, the pollution control equipment had to be certified as a new, identifiable treatment facility which is used in an existing plant to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat. Certification was required by appropriate State and Federal authorities that the equipment complied with the appropriate standards.

In addition to the rapid amortization provision that had been in effect through last year, taxpayers who placed pollution control equipment in service might be able to finance the cost of acquisition, in whole or in part, through the issue of industrial development bonds. Several conditions and limitations apply to the issue of these bonds in section 103 of the Code, and all taxpayers may not be able to qualify to issue these tax-exempt bonds. Taxpayers who did not elect rapid amortization were able to use accelerated depreciation on ADR guideline lives and the investment credit. In many cases, this combination gave greater tax benefits than five-year amortization.

Reasons for change

Expiration of the 5-year amortization provision was an unintended result at the end of 1975. The committee reported a bill late last year that would have extended section 169 for another year, but the bill could not receive consideration by the Senate at the end of the session.

The committee believes that reenactment of this provision is necessary in order to provide a tax incentive for installing pollution control equipment. This equipment is placed in service because public policy now requires that the cost of dealing with pollution be included in the prices of products as a cost of production. This transfers the cost burden of removing pollution created by the production process to the consumers of the product from the victims of pollution. The producers must install equipment that frequently is expensive and usually does not increase productivity. Although the costs can be recovered during the useful life of the equipment, the cost is incurred at the outset. In recognition of this addition to a businessman's capital costs because of a change in public policy, the committee believes that this additional assistance in reducing the cost burden is appropriate.

After restoration of the investment credit in 1971, the amortization provision was used infrequently because the investment credit plus accelerated depreciation over ADR guideline lives provided better tax benefits. The committee believes that the investment credit also should be made available in combination with rapid amortization to restore the viability of the amortization provision as an incentive.

As it has been administered since its enactment, pollution control has been interpreted as a process that takes place at the end of the production process. The committee believes that interpretation has been excessively narrow, and it amended section 169 to permit a broader definition of pollution control.

Explanation of the provision

The committee restored the five-year amortization provision to the Code as of January 1, 1976, as a permanent provision. It applies to pollution control facilities installed in plants in operation before January 1, 1976. The provision is unchanged from the committee's earlier version, except for the change in the definition of pollution control to include "preventing the creation or emission of" pollutants. Under the amended definition, a new identifiable facility may qualify for rapid amortization, if it prevents the creation of pollutants during the course of operating the plant. For example, a taxpayer might install equipment in the sequence of production operations that prevents the creation of pollution by removing potential contaminants from the material one production stage before pollutants ordinarily would be generated or emitted. If an electric utility could treat high sulphur content coal just before it is burned so that there would be no sulphur emitted in the smoke or in any other way, the equipment that provides the treatment would qualify as a new identifiable treatment facility. A production process that is different because it does not generate any pollutants does not qualify as a new identifiable treatment facility that prevents the creation of pollution.

The investment credit is made available for certified pollution control equipment for which the taxpayer has made an election for rapid amortization. Since rapid amortization provides a useful life for depreciation purposes of five years, this equipment is eligible for two-thirds of the investment credit.

Effective date

Restoration of the election for five-year amortization is effective with respect to certified pollution control equipment which is placed in service after December 31, 1975. The investment credit will be available for such equipment placed in service after December 31, 1976.

Revenue effect

This provision will increase tax receipts by $52 million in fiscal year 1977 and by $75 million in fiscal year 1978. There will be decreases in tax receipts of $199 million in fiscal year 1981.

14. Qualification of Fishing Organizations as Tax-Exempt Agricultural Organizations (sec. 1314 of the bill and sec. 501(g) of the Code)

Present law

Agricultural organizations are exempt from tax under section 501 (c)(5) of the Code. Organizations devoted to promoting or improving fishing or such related occupations as taking lobster or shrimp are not treated as agricultural organizations by the Internal Revenue Service.[1] However, organizations devoted to promoting or improving fishing and related pursuits may qualify for tax exemption under section 501 (c) (6) as business leagues.[2]

Reasons for change

There seems to be no valid reason for differentiating under section 501(c) (5) between occupations devoted to producing foodstuffs from the earth and occupations devoted to producing foodstuffs from water. This distinction has some practical consequences now—e.g., organizations or leagues devoted to fishing and related pursuits are not entitled to the reduced postal rates granted to exempt agricultural organizations. The distinction may have further practical and undesirable consequences in the future unless it is eliminated.

Explanation of provision

The committee amendment adds a new provision (new subsection (g) of 501)to explain the meaning of "agricultural" in section 501(c) (5). The amendment provides that "agricultural" includes (but is not necessarily limited to) the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.

The term "harvesting * * * aquatic resources" includes fishing and related pursuits (such as the taking of lobsters and shrimp). Both fresh water and salt water occupations are to qualify as "agricultural" under the new definition. In addition, the cultivation of underwater vegetation, such as edible sea plants, qualifies as agricultural in nature,[3] as does the cultivation or growth of any edible organism. Also, the operation of "fish farms" is to be considered agriculture under the new definition. However, aquatic resources are only to include animal or vegetable life, not mineral resources.

There is no corresponding provision in the House bill.

Effective date

This provision is to be effective for all taxable years beginning after December 31, 1972.

Revenue effect

It is estimated that this provision will have no revenue impact.

15. Subchapter S Corporation Shareholder Rules (sec. 1315 of the bill and sec. 1371 of the Code)

Present law

Subchapter S was enacted in 1958 in order to minimize the effect of Federal income taxes on businessmen's choices of the form of business organization in which they conduct their businesses, and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder

[1] The provisions of the Code defining agricultural pursuits or farming do not encompass fishing and similar pursuits. (See secs. 3121(g) and 6420(c).)

[2] Payments to section 501(c)(5) organizations or to section 501(c)(6) organizations are not deductible as charitable contributions. However, in most cases they are deductible as business expenses.

[3] No inferences are to be drawn from this provision as to whether any pursuit that may qualify under the new term "harvesting * * * acquatic resources" does or does not qualify under existing law.

levels. The subchapter S rules allow corporations engaged in active trades or businesses an election to be treated for income tax purposes in a manner similar to that accorded partnerships. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock.

An election under subchapter S is made by, and requires the consent of, all shareholders. It may be terminated either voluntarily or involuntarily in certain circumstances.

In order to be eligible for subchapter S treatment, the stock ownership of the corporation must meet certain qualifications. First, it must be a corporation with only one issued and outstanding class of stock. In addition, the corporation is required to have 10 or fewer shareholders, all of whom are individuals or estates and none of whom are trusts or nonresident aliens.[1]

For purposes of determining the number of shareholders, present law provides that stock which is community property of a husband and wife (or the income from which is community property income) under the law of a community property State will be treated as owned by one shareholder. Similarly, a husband and wife are treated as one shareholder where they own the stock as joint tenants, tenants in common, or tenants by the entirety.

Reasons for change

One of the most common uses of the subchapter S election has been in the situation of a family owned or controlled corporation. During the eighteen years that subchapter S has been in effect, many corporations which have been electing corporations during much of this period, and their shareholders, find that their subchapter S status is imperiled because of the 10-shareholder limitation. This often occurs where one of the original shareholders retires from the family business and transfers the stock to his children or leaves it to them in his will. In addition, the death of a spouse may cause a problem under this rule. Although a husband and wife were treated as one shareholder, the deceased spouse's estate is considered to be a separate shareholder. Because of these difficulties and in order to maintain the viability of the subchapter S corporation for family owned businesses, the committee has decided to make several changes in the 10-shareholder rule.

Explanation of provision

The committee amendment makes several changes in the stock ownership rules in the subchapter S provisions. First, the number of shareholders permitted in order for a corporation to qualify for and maintain subchapter S status is increased from 10 to 15, after the corporation has been an electing subchapter S corporation for 5 taxable years. Under this rule, an electing corporation may have no more than 10 shareholders during the first 5 years of its subchapter S status, but may increase its number of qualifying shareholders to 15

[1] In addition to the stock ownership requirements, the corporation must be a domestic corporation and may not be a member (parent corporation) of an affiliated group of corporations eligible to file consolidated income tax returns.

after this period, provided that the corporation satisfies the other conditions for maintaining its status, such as timely consent to the election by the new shareholders. The 5-year period in this provision means 5 consecutive taxable years of the corporation.

The amendment is also intended to provide that once the corporation has satisfied the 5-year rule under any subchapter S election, it qualifies for the additional 5 shareholders even though this election has been terminated or revoked and it has subsequently made a new subchapter S election. This is to prevent a potential problem where an electing corporation's status is terminated or revoked after it has satisfied the 5-year rule and the number of shareholders has increased to more than 10. Under existing statutory rules, a corporation whose subchapter S status has been terminated or revoked is not eligible, without the permission of the Secretary, to make a new election for subchapter S treatment until the sixth taxable year following the last year the previous election was in effect. If the corporation is required to satisfy the 10-shareholder 5-year rule after this new election, the rule could force divestitures (or encourage sham transactions) by as many as 5 of the shareholders. Since this rule would create hardships in some situations, such as a family-owned small business, the committee believes that the 5-year rule should not be required to be satisfied in conjunction with a subsequent election where it was previously satisfied under an earlier election and the corporation had in fact more than 10 shareholders on the last day of the last taxable year covered by the previous election.

Both of the other committee amendments relate to situations where ownership of a subchapter S corporation's stock changes as a result of the death of a shareholder. One of the amendments provides in excess of 10 (but in no event more than 5 additional shareholders) during the 5-year period if the initial additional shareholders acquire their stock by inheritance.

In order not to restrict the transferability of the shares (during the 5-year period) by the inheriting shareholders, these shareholders may sell or otherwise transfer their shares during the 5-year period to a noninheriting shareholder without violating the 5-year requirement. However, the total number of shareholders during the 5-year period holders. For this purpose, the term "inheritance" is given a broad definition to include the passing of property by legacy, devise or intestate succession.

In order to conform to existing provisions which treat husband and wife as one shareholder and to mitigate the effect of the shareholder rules where one spouse dies, the committee also decided to permit the surviving spouse and the estate of the deceased spouse to be treated as one shareholder where the husband and wife were considered one shareholder at the time of death of the decedent.

Effective date

These amendments are effective for taxable years beginning after December 31, 1976.

Revenue effect

The revenue loss from the amendments is estimated to be negligible.

16. Innocent Spouse (sec. 1316 of the bill and sec. 6013(e) of the Code)

Present law

Under present law (sec. 6013(e)), an innocent spouse may be relieved of the generally applicable rule of joint and several liability on a joint return if the liability is attributable to omissions of income for which the spouse seeking relief is not responsible. Relief could have been sought for all taxable years which were still open when that provision was enacted (January 12, 1971), but could not be granted for a year which was already closed by the statute of limitations, res judicata, or otherwise.[1]

If certain conditions are met, relief may be granted to an innocent spouse who filed a joint return which omitted income in excess of 25 percent of the income actually reported. The spouse seeking relief must establish that he or she did not know of and had no reason to know of the omission. Also, it must be concluded that it is inequitable to hold the innocent spouse liable for the tax deficiency. A determination about whether it is inequitable to hold an innocent spouse liable must be based on all the facts and circumstances and must consider whether the innocent spouse benefitted significantly from the omitted income.

Relief under this provision covers liability for tax, interest, penalties and other amounts. Although Congress was especially concerned with granting relief to innocent spouses of embezzlers who fail to report income fully, the relief may cover any type of omission.

Reasons for change

The committee believes that relief should be granted in certain cases where an innocent spouse is unable to obtain relief under present law solely because a judicial decision has rendered an issue res judicata. The committee believes it appropriate to alleviate the undue hardship imposed on an innocent spouse (1) who became liable for tax because of the res judicata effect of a judicial decision prior to the enactment of this provision and (2) who could have benefitted from the provision if he or she had kept the taxable year in question open within the tax administrative process and had not sought judicial relief.

Explanation of provision

The committee amendment grants relief under the innocent spouse provision to certain taxpayers, who but for the res judicata effect of adverse judicial decisions prior to the provision's enactment, would have been relieved of liability for unreported income. The House bill contains no corresponding provision.

Under the committee amendment, a taxpayer may apply under section 6013(e) for redetermination of his or her tax liability for taxable years beginning within ten years prior to the enactment of section 6013(e) and ending on or before January 12, 1971, the date of enactment of that provision, if such relief has been barred solely by operation of res judicata. A redetermination sought under the committee amendment is to be made without regard to the res judicata effect of a judicial decision. Taxpayers found to have overpaid their taxes are to be entitled to refunds.

[1] H. Rept. 91–1734, p. 5 (1970); S. Rept. 91–1537, p. 4 (1970).

Effective date

The application permitted by the committee amendment must be made before the end of the first calendar year beginning after the date of enactment of this Act.

Revenue estimate

It is estimated that this provision involves a negligible revenue loss.

17. Rules Relating to Limitations on Percentage Depletion in Case of Oil and Gas Wells (sec. 1317 of the bill, and sec. 613A of the Code)

Present law

Prior to the Tax Reduction Act of 1975 any taxpayer was entitled to a deduction for the greater of the percentage depletion allowance or the cost depletion allowance on gross income from an oil and gas property. The allowance was equal to 22 percent of such gross income, but not more than 50 percent of the taxable income from such property.

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for oil and gas with two exceptions. Under the first exception, natural gas sold under a fixed contract or subject to federal price regulation is still eligible for percentage depletion computed without regard to the limitations on percentage depletion contained in the Tax Reduction Act of 1975. Under the other exception (the "small producer exemption"), percentage depletion is allowed for a limited amount of production from wells located within the United States. The amount of production eligible for percentage depletion is an average of 2000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter. The percentage depletion rate for eligible production remains at 22 percent through 1980 and then is gradually reduced annually to 15 percent for 1984 and years thereafter. However, production resulting from secondary and tertiary processes remains eligible for the 22 percent rate through 1983.

For any taxpayer eligible for the small producer exemption, the deduction for any year attributable to such small producer exemption may not exceed 65 percent of the taxpayer's taxable income. However, if a taxpayer acquired an interest in an oil and gas property after 1974 and the property is "proven" at the time of transfer, the taxpayer is generally not allowed percentage depletion on production from that property under the small producer exemption. Also, a taxpayer is not eligible for the small producer exemption on any oil or gas production during any period for which such taxpayer is classified as a "retailer" of oil or gas, or products derived from oil or gas. Finally, a taxpayer is ineligible for the small producer exemption for any taxable year for which the taxpayer (or a related person) engages in refining of crude oil if, on any day during the year, he has refinery runs exceeding 50,000 barrels.

Generally, a taxpayer is subject to the "retailer" exclusion for any taxable year in which the taxpayer either directly, or through a related person, sells oil or gas (or any product derived from oil or gas) either (a) through a retail outlet operated by the taxpayer or a related person, or (b) to any person who is obligated under a contract with the taxpayer (or a related person) to use the trademark, etc. of the taxpayer (or a related person) in marketing oil and gas (or derivative products), or who is given authority under a contract to occupy a retail outlet controlled by the taxpayer.

Reasons for change

Certain provisions of the Tax Reduction Act of 1975 relating to percentage depletion have been or may be interpreted in a manner which is inconsistent with what the committee believes to be the intent of Congress in enacting that legislation. In some cases, the literal language of the statute requires unintended results. In other cases, the statutory language is ambiguous.

First, the retailer exclusion can be construed to apply in many cases where it was not intended to apply. For example, the retailer exclusion could be interpreted to deny the small producer exemption to a royalty interest holder who also holds a mere 5-percent interest in a partnership that operates a corner drugstore which sells petroleum jelly. The committee believes that the retailer exclusion was intended to apply only where the taxpayer has substantial retail operations and not to cases where a taxpayer's retail operations are essentially *de minimis*. In addition, the committee believes that the retailer exclusion should be applied only in the case of retail sales as that term is commonly used. Thus, bulk sales of oil or natural gas directly to industrial or commercial users should not be treated as retail sales through a retail outlet. Nor should retail sales be taken into account if they take place outside the United States, provided the taxpayer is not exporting oil, gas. or derivative products.

The rule prohibiting the percentage depletion deduction on proven property which has been transferred was intended to prevent a proliferation of the amount of proven oil and gas reserves that might be 'eligible for percentage depletion when produced. The committee believes that the rule was not intended to apply to some cases of transfers which occur by operation of law. For example, where a property is held in trust and the beneficiaries are entitled to percentage depletion with respect to the property, the birth or death of a beneficiary may constitute a transfer. This kind of a transfer was not intended to give rise to the denial of percentage depletion.

Finally, it has come to the attention of the committee that the Treasury Department has encountered administrative difficulties as a result of certain technical problems in the new depletion rules. To correct any possible defects, the committee agreed to certain technical amendments for clarification.

Explanation of provisions

The committee's amendment makes several changes in the retailer exclusion. If, in the case of any taxpayer, gross receipts from the sale of oil or gas, or products derived therefrom, by all retail outlets of the taxpayer (or related persons) do not exceed $5 million for the taxable year, such taxpayer will not be treated as a retailer for that year. Thus, if the taxpayer and related persons operate a total of five outlets, the taxpayer will be subject to the retailer exclusion only if the aggregate gross receipts from the sale of oil, gas, or their derivative products by these outlets exceeds $5 million for the year. This *de minimis* exception applies to retail outlets occupying land owned, leased or controlled by the taxpayer as well as those outlets owned directly by him.[1] Also, a taxpayer will not be subject to the retailer exclusion for any taxable year for which all retail sales of oil, gas, or their derivative products by retail outlets are made outside the United States, provided that no domestic production of the taxpayer or a related person is exported during the year in question or the immediately preceding taxable year.

The committee's amendment adds an additional exception to the transfer rule. Under this exception, no change of beneficiaries of a trust shall be considered a "transfer" if the change occurs solely by reason of the death, birth, or adoption of any beneficiary if the transferee was a beneficiary under the trust prior to the triggering event or is a lineal descendant of the grantor or any other beneficiary.[2]

Under the trust laws of certain States, as well as the provisions of some existing trust instruments, the entire depletion allowance is required to be allocated to the trustee, even though income distributions are made to beneficiaries. Such distributions reduce the taxable income of the trust and, because of the 65 percent limitation, jeopardize the deduction under the small producer exemption. The committee believes that this result was not intended. Thus, to correct this situation, the committee's amendment provides, for purposes of the 65-percent-of-taxable-income limitation, that a trust's taxable income shall be computed without a deduction for distributions to beneficiaries during the taxable year. In addition, the language of present law is changed to make clear that in computing taxable income for purposes of the 65-percent-of-taxable-income limitation, percentage depletion under the small producer exemption is not treated as a deduction from taxable income. (Otherwise, there would be a circle, with percentage depletion reducing the base of taxable income against which the 65-percent limitation is measured.) However, if a property is exempted from the provisions of these limitations on percentage depletion (because it produces a regulated natural gas, etc.), then taxable income would be reduced by the depletion taken. Also, if the cost depletion deduction allowable on one or more of the taxpayer's oil or gas properties is greater than the percentage depletion deduction allowed under this section (without regard to the limitation based on taxable income) then the entire amount of allowable cost depletion must be deducted in computing taxable income for purposes of the 65-percent limitation.

Under present rules, percentage depletion is to be computed by each partner in the case of an oil or gas property held by a partnership. Some partners may be limited to cost depletion by reason of the various limitations and exclusions, while other partners will be entitled to percentage depletion. Whatever depletion allowance is deducted by the partners reduces the basis of the partnership property. The basis affects the amount of the cost depletion allowance for any year, as well as the amount of gain or loss recognized upon a sale or exchange of such property.

[1] For purposes of the retailer exclusion, bulk sales by the producer of oil or natural gas directly to commercial or industrial users are not to be taken into account. Therefore, this type of sale is also not to be taken into account for purposes of the *de minimis* rule.

[2] For this purpose, an individual adopted by a beneficiary is a lineal descendant of that beneficiary.

In the case of partnerships having numerous partners, difficulty arises if the partnership is required to maintain the basis account for partnership oil or gas property. The partnership would have to ask that each partner inform the partnership annually of the amount of depletion deducted with respect to each property. This practice would be burdensome and unreliable. Moreover, if the basis of the property were maintained at the partnership level, deductions by partners entitled to percentage depletion would reduce the basis and jeopardize the cost depletion allowance for those partners not entitled to percentage depletion. Also, on a subsequent sale of the property, partners limited to cost depletion would recognize the same portion of gain or loss as those partners entitled to percentage depletion. These results were not intended under the Tax Reduction Act of 1975 which provided that percentage depletion under the small producer exemption is to be compiled at the partner level). Accordingly, the committee amendment clarifies existing rules so that the partnership basis in oil or gas properties is allocated to partners proportionately. Thereafter, each partner maintains an individual basis account and computes his own allowance for either percentage depletion or cost depletion on all his oil and gas properties.[3]

As noted in the discussion above, under present law a retailer (or a refiner) is not eligible for the small producer exemption if he directly, or through a related person, sells oil, natural gas, or products derived therefrom through a retail outlet (or annually refines a certain amount of crude oil). The definition of a related person is based on a significant ownership test. However, the definition under present law does not specify that a significant ownership interest is held when a person indirectly holds a significant ownership interest in another person. In order to prevent taxpayers from avoiding the retailer and refiner exclusions by the use of intermediate entities, the committee amendment clarifies present law by specifically providing that in determining whether a significant ownership interest is held, an interest owned by or for a corporation, partnership, trust, or estate shall be treated as owned directly both by itself and proportionately by its shareholders, partners, or beneficiaries, as the case may be.

Effective date

These provisions are effective for taxable years beginning after December 31, 1974 (the effective date of the provisions relating to the percentage depletion deduction in the Tax Reduction Act of 1975).

Revenue effect

This provision will reduce budget receipts by $18 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981.

18. Federal Collection of State Individual Income Taxes (sec. 1318 of the bill and secs. 6361 and 6362 of the Code)

Present law

Under current law, a State may elect to have the Internal Revenue Service collect the State's individual income tax if the State enters

[3] For this purpose, the partner adjusts his basis for his individual deductions for depletion and he separately computes gain or loss on the proceeds from the sale or exchange of an oil or gas property.

into an agreement with the Internal Revenue Service, if the State individual income tax is a qualified tax, and at least two States, representing 5 percent or more of the Federal individual income tax returns in 1972 have elected to have their individual income taxes "piggybacked" onto the Federal income tax system.

Three types of State taxes are qualified: taxes on residents income based on Federal taxable income at rates determined by the States; taxes on residents' income which are a percentage of the Federal liability; and taxes on nonresidents' wage and other business income.

Generally, for a tax based on taxable income to qualify for Federal collection, the State tax must be imposed on an amount equal to an individual's taxable income for the taxable year, as such income is defined from time to time in the Internal Revenue Code of 1954 (sec. 63). However, because taxable income does not in all respects provide an appropriate base for State tax, current law requires that three adjustments be made to the tax base in order for the tax to qualify for Federal collection: (1) subtract from Federal taxable income any interest received on U.S. obligations received by a taxpayer and included in Federal gross income, (2) add to Federal taxable income any deductions claimed by a taxpayer for net State and local taxes, and (3) add to Federal taxable income the interest from obligations of States or political subdivisions which is exempt from Federal income tax. Current law also permits a State to impose a "minimum tax" on tax preferences and to allow a credit for income taxes paid to another State or a political subdivision of another State.

A qualified resident tax computed as a percentage of Federal tax is defined as one imposed on the excess of the taxes imposed by chapter 1 of the Internal Revenue Code over the sum of the nonrefundable credits allowable against these taxes. This includes in the base the Federal liability for the minimum tax. As with the tax based on Federal taxable income, certain adjustments are provided by the Act for the tax based on a percentage of the Federal tax, as follows: (1) decrease liability on account of interest on U.S. obligations included in Federal taxable income, (2) increase liability by including net tax-exempt income, (3) increase liability by adding back net State income tax deduction, and (4) allow a credit for income tax paid to another State (or political subdivision).

Finally, a nonresident tax will not be qualified unless the amount of tax imposed by a State on the income of a nonresident does not exceed the tax that would be imposed by the State if he were a resident and if his taxable income were an amount equal to the excess of his wage and other business income derived from sources within the State, over that portion of the nonbusiness deductions allowable under the State's qualified resident tax which bears the same ratio to the total of such deductions that the wage and other business income derived from sources within the State bears to the taxpayer's adjusted gross income.

Reasons for change

To date, the requisite two States with 5 percent or more of 1972 Federal individual income tax returns have not "triggered" the piggyback system. This reluctance on the part of the States stems from apparent uncertainty about whether or not the Federal Government would bear the costs of administering the collection of State taxes, even though the 1972 legislation contemplated that the Federal Government and not the States, would bear those costs. Also, there has been concern that certain progressive features of current State individual income taxes would be eliminated were a State to elect to piggyback. Also, there may have been coordination problems among several States to jointly elect and therefore trigger the piggyback system.

To remove those impediments, the committee amendment (1) makes it clear that the Federal government will bear the costs of piggybacking, (2) permits States to provide sales tax credits, and (3) eliminates the 5-percent-of-returns rule and lowers the trigger to one State.

Explanation of provision

The committee amendment makes explicit Congress' intent that the Federal Government will not charge any State, directly or indirectly, for Federal administration of the State's income taxes under the piggybacking provisions.

The committee amendment also reduces to one State the number of States needed to set off this trigger, and removes the requirement of present law that the initially-electing State or States must represent, in the aggregate, 5 percent or more of the Federal individual income tax returns filed during 1972.[1] This has the effect of permitting a State to make its decision whether to elect piggybacking based on its own needs, without having to predict whether that State will be joined by other States of any given size.

Finally, the committee amendment permits a State to provide a credit for State sales tax against State income tax. Such credits are increasingly being made available under existing State laws and are generally designed to reduce the regressive effects of flat-rate State sales taxes, especially when such taxes are imposed on food.

The House bill does not contain any comparable provisions.

Effective date

This provision is to take effect on the date of enactment.

Revenue effect

This provision is not expected to have any effect on Federal revenues.

19. Exclusion of Income From Certain Cancellation of Indebtedness Under Student Loan Programs (sec. 1319 of the bill and sec. 117 of the Code)

Present law

Under present law, gross income means all income, from whatever source derived, including income from discharge of indebtedness, unless otherwise provided by law (sec. 61). Subject to certain limitations, gross income does not include any amount received as a scholarship at an educational institution or as a fellowship grant (sec. 117(a)). An

[1] While the trigger is reduced to one State, piggybacking becomes effective within the notification process of current law, i.e., the first January 1 which is more than one year after the date of notification.

amount paid to an individual to enable him to pursue studies or research does not qualify as a scholarship of fellowship grant if such amount represents compensation for past, present or future employment services or if such studies or research are primarily for the benefit of the grantor (Regs. § 1.117-4(c)).

Under certain student loan programs established by the United States and various State and local governments, all or a portion of the loan indebtedness may be discharged if the student performs certain services for a period of time in a certain geographical area pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled, with regard to a State medical education loan scholarship program which provides that portions of the loan indebtedness are discharged on the condition that the recipient practices medicine in a rural area of the State. The condition that services be performed in an area selected by the grantor imposes a substantial *quid pro quo*, so that the services are primarily for the benefit of the grantor. Amounts received from such a loan program must therefore be included in the gross income of the recipient to the extent that repayment of a portion of the loan is no longer required (Rev. Rul. 73-256, 1973-1 Cum. Bull.). On November 4, 1974, the Service determined that this ruling would be applied only to loans made after June 11, 1973, the date of the above ruling (Rev. Rul. 74-540, 1974-2 Cum. Bull. 38).

Reasons for change

Many States and cities have experienced difficulty in attracting doctors, nurses and teachers to serve certain areas, including both small communities and low-income urban areas. A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. Proponents of these programs believe that the loan cancellation is not primarily for the benefit of grantor, as the Service has ruled, but for the benefit of the entire community and that the exclusion from income of the amount of indebtedness discharged in exchange for these services would further the purpose of these programs. In addition, proponents believe such exclusion would be consistent with the treatment of scholarships and fellowship grants which are not contingent upon the performance of needed services by the recipient.

Explanation of provision

The committee amendment provides that no amount shall be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs if the discharge was pursuant to a provision of the loan agreement under which all or part of the indebtedness of the individual would be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. This provision applies to student loans made to an individual to assist him in attending an educational institution only if the loan was made by the United States or an instrumentality or agency thereof or by a State or local government, either directly or pursuant to an agreement with an educational institution.

The House bill has no comparable provision. The report of the House committee states that that committee will, with the assistance of the Internal Revenue Service, study the tax treatment of scholarships and fellowships, including student loans that are forgiven. To allow further study in this area, the provisions of this section are effective through December 31, 1978.

Effective date

The amendment made by this section shall apply with respect to loans forgiven prior to January 1, 1979.

Revenue effect

It is estimated that this provision will have only a negligible revenue loss.

20. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 1320 of the bill and sec. 337 of the Code)

Present law

Under present law, a corporation which adopts a plan of complete liquidation and, within 12 months thereafter, sells or exchanges some or all of its assets and liquidates completely generally does not recognize gain or loss from the sale or exchange (sec. 337). The receiving shareholders will ordinarily be taxable on the sale proceeds (sec. 331).

This corporate nonrecognition rule does not apply, however, if the corporation making the sale or exchange is an 80 percent or greater controlled subsidiary of a parent corporation and if the parent takes a carryover basis in the assets of the subsidiary when it liquidates the subsidiary (sec. 337(c)(2)).

Reasons for change

The purpose of the general rule freeing the corporation from tax on a sale of its assets followed by a complete liquidation is to eliminate the need for determining whether a corporation in the process of completely liquidating, which distributes some of its assets to its own shareholders who then complete a sale of the assets to a third party, should be treated for tax purposes as remaining taxable on the sale or whether the shareholders receiving the assets should be treated as taxable on the sale. However, if a corporate shareholder of a company which sells its assets is not taxable when it liquidates the subsidiary (as occurs under sec. 332), and if the subsidiary were not taxable on a gain from selling its assets, no tax at all would be paid on the gain represented by the sale proceeds. Hence, present law taxes a controlled subsidiary where it sells its assets and then liquidates into its parent (sec. 337(c)(2)).

In some situations, however, where both the parent and the subsidiary plan to liquidate after a sale of property by the subsidiary it is less important to tax the subsidiary on its gain from a sale of assets. In fact, a sale of assets by the subsidiary will be subject to tax under section 337(c)(2) and the shareholders of the parent corporation will also recognize gain when the parent liquidates. The Internal Revenue Service has held that this tax result can be avoided under present law if the parent first liquidates the subsidiary into itself (without recognizing gain or loss by reason of sec. 332) after which the parent adopts its own plan of liquidation (under sec. 337) and sells the assets formerly owned by the subsidiary. Under that sequence, neither the parent nor its subsidiary would recognize gain or loss and the parent's shareholders would recognize gain or loss on the liquidation of the parent.[1]

The committee believes that, consistent with the underlying purpose of section 337, the sequence of formal steps taken by the parties in this type of situation should not determine what tax results occur.

Explanation of provision

The committee amendment modifies the rules relating to recognition of gain or loss on a sale of property by a controlled subsidiary which sells property and then liquidates into its parent corporation. There is no comparable provision in the House bill.

The rule added by the bill permits the general nonrecognition rule of section 337(a) to apply to a controlled subsidiary which sells property and then liquidates completely, provided that the parent corporation also liquidates completely in the same transaction. In order to obtain nonrecognition of gain or loss, all other generally applicable requirements of section 337 would have to be satisfied (such as the rule that the sale or exchange of property must occur within 12 months after the subsidiary adopts a plan of complete liquidation). This amendment requires, however, that in this situation not only must the selling subsidiary make a liquidating distribution of all of its remaining assets (less assets retained to meet claims) within 12 months after its plan of liquidation is adopted, but, in addition, during the same 12 month period, the parent corporation must also distribute all of its assets in its own complete liquidation. (The parent will be regarded as having liquidated completely for purposes of this rule even though it retains assets to meet claims).

Because sec. 337(a) will be applicable in this situation, gain on a sale of the subsidiary's assets will not be recognized by the subsidiary if the subsidiary makes the sale or, under the so-called "Court Holding Company principle," a sale by the parent is treated for tax purposes as having been made by the subsidiary.[2] A realized loss on a sale by the subsidiary of property which has declined in value will similarly not be recognized.

If the selling subsidiary is a member of a group of controlled subsidiaries having a common parent corporation, the amendment requires in effect that all other subsidiaries in the direct line of stock ownership above the level of the selling subsidiary must also liquidate completely. These other subsidiaries must distribute their assets (less assets retained to meet claims) in complete liquidation within the 12 month period beginning on the date of adoption of the selling subsidiary's plan of liquidation.[3]

[1] The Internal Revenue Service has approved this procedure. See Rev. Rul. 69-172, 1969-1 Cum. Bull. 99.

[2] See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945) and *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950).

[3] For purposes of this rule, the group of corporations to which this rule will apply must constitute an "affiliated group" as defined in section 1504(a) of present law. An affiliated group will qualify under this provision regardless whether the group elects (under sec. 1501) to file a consolidated tax return. Also for purposes of this rule, the exceptions to the definition of "includible corporation" contained in section 1504(b) of present law are not to apply. Therefore, the members of the affiliated group are to be determined as if the corporations referred to in section 1504(b) were members of the group.

The amendment made by the committee will apply both where the parent of the subsidiary which made a sale or exchange of property takes a carryover basis in the subsidiary's assets (i.e., a basis determined under sec. 334(b)(1) and where the parent takes a basis equal to its cost for the subsidiary's stock (under sec. 334(b)(2)).

Effective date

This provision is effective for sales or exchanges made pursuant to a plan of liquidation adopted on or after January 1, 1976.

Revenue effect

It is estimated that this provision will not have any significant effect on tax revenues.

21. Prohibition of State-Local Taxation of Certain Barges Using Interstate Waterways (sec. 1321 of the bill)

Present law

Although Congress has the power to regulate interstate commerce, few Federal limitations upon the power of States to tax transactions in interstate commerce have been enacted. Public Law 86–272 [1], however, placed certain minimum standards upon the power of States to tax nondomiciliaries selling in the taxing State.

Congress has also done little to limit the power of States to tax common carriers in interstate commerce. However, Public Law 94–210,[2] the Railroad Revitalization and Regulatory Reform Act of 1976, does prevent States from taxing railroads at rates higher than those placed on other commercial property. Congress has not limited the power of States to tax vessels using navigable waterways.

Reasons for change

The committee has learned that there is at least one instance of a tax being levied by a political subdivision of a State upon barges using navigable waters of the United States. The committee is concerned that a proliferation of such local taxes, or of State taxes upon such barges, would place unduly heavy record-keeping and financial burdens upon the barge operators, and might well result in discriminatory taxation that will prove burdensome to interstate commerce.

Explanation of provision

The committee amendment prohibits any State or political subdivision of a State from taxing any vessel (or barge or other craft) using the navigable waters of the United States in interstate commerce. For the purposes of this limitation, it is understood that the term "interstate commerce" is to include not only the actual carrying of passengers or goods for hire, but also is to encompass return trips to the home port when the vessel may be carrying no passengers or cargo, trips to a port to bring on passengers or cargo, trips for the purpose of repair, and such other uses of navigable waters which caselaw or statutory law has deemed to be included in the term "interstate commerce."

This provision is not intended to limit the traditional taxing jurisdictions specifically recognized in the amendment. Therefore, this pro-

[1] 86th Cong., 1st Sess., 73 Stat. 555 (1959).
[2] 94th Cong., 2d Sess., 90 Stat. 31 (1976).

hibition of local or State taxation is not to apply to any State or political subdivision of a State in which the craft is incorporated. The prohibition does not apply to taxation of any craft owned by an individual, partnership, or corporation which is domiciled in, or is a resident of, the State imposing the tax, or the State in which the political subdivision imposing the tax is situated. Finally, the prohibition does not apply to any tax of a State or political subdivision of a State in which the political subdivision imposing the tax is situated. Finally, the prohibition does not apply to any tax of a State or political subdivision of a State in which the craft has its home port. ("Home port" is to have the customary meaning given that term by caselaw, admiralty, or other rules and regulations.)

The House bill contained no similar provision.

Effective date

This prohibition applies to taxes imposed for any taxable year (of the individual, partnership, trust, estate, or corporation being taxed) ending after June 30, 1976.

Revenue effect

This provision will have no effect upon the Federal revenues.

22. Contributions to Capital of Regulated Public Utilities in Aid of Construction (sec. 1322 of the bill and secs. 118 and 362 of the Code)

Present law

Under present law, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation take a zero basis in the hands of the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received or of certain other property is reduced by the amount of such contribution (sec. 362(c)).

Certain regulated public utilities (water and sewage disposal) have traditionally obtained a substantial portion of their capital needed for the construction of facilities through contributions in aid of construction. The concept of contributions in aid of construction originates from a line of early Board of Tax Appeals decisions dealing with amounts contributed by customers to public utilities to pay for extensions of service lines necessary to enable them to be serviced by the public utility. The decisions treated such amounts as not giving rise to taxable income to the public utilities.

In a 1958 ruling, the Internal Revenue Service announced that it would continue to follow the early case law with respect to contributions in aid of construction, but only with respect to *regulated* utilities. The ruling also indicated that any change of position would be given nonretroactive effect (Rev. Rul. 58–535, 1958–2 C.B. 25). In 1975, the Service issued Revenue Ruling 75–557 which revoked the 1958 ruling, withdrew the IRS's acquiescence in the early line of cases, and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service are includible in the utility's income. The current ruling is made prospective for transactions entered into on or after February 1, 1976.

Reasons for change

The effect of the recent IRS ruling is to increase substantially the taxes of those utilities which had previously treated all contributions in aid of construction as nontaxable contributions to capital. These increased taxes will ultimately result in higher charges to utility customers. Since such increased charges must be approved by public utility commissions, the working capital of the utilities may be substantially reduced resulting in delays in furnishing service and curtailment of expansion of service. Further, the immediate inclusion of such contributions in income causes a mismatching of income and related expense since the utility must increase income in the year in which the contributions are received, even though most of the expenses attributable to those facilities will not arise until subsequent years.

The committee believes that treatment of contributions in aid of construction by water and sewage disposal utilities should be continued by providing that contributions in aid of construction received by such utilities from an existing or potential customer, a builder or developer, a governmental body, or any other person will constitute a contribution to capital.

Explanation of provision

This provision amends the current rules concerning nonshareholder contributions to capital by specifying that amounts received as contributions in aid of construction by a water or sewage disposal utility (described in section 7701(a)(33)(A)(i)) which are used for qualified expenditures and which are not included in the rate base for rate making purposes by the regulatory body having rate-making jurisdiction will be treated as nontaxable contributions to the capital of the utility.

For this purpose, the Secretary is to prescribe rules defining what items and amounts constitute a contribution in aid of construction. The following are examples of facilities which the committee considers to be contributions in aid of construction.

(1) A builder or developer constructs water lines and/or support facilities such as water filtration plants, water towers, etc., and turns such facilities over to a regulated water or sewage disposal utility.

(2) A builder or developer furnishes the necessary funds to a regulated water or sewage disposal utility which uses those funds to build certain water or sewage disposal facilities.

(3) A builder or developer pays for the water or sewage disposal facility (commonly referred to as an "advance"). In return for the qualifying utility agreeing to pay the developer a percentage of the receipts from the facilities over a fixed period. Where the total payments made to the developer are less than the cost of the facilities which are transferred to the utility, any difference is to be treated as a contribution in aid of construction.

(4) A customer pays a fee to reimburse the utility for lines, valves, pipes, or meters, or a customer constructs his own lines which are turned over to the water or sewage disposal utility.

(5) Governmental units furnish regulated water or sewage disposal utilities with relocation fee payments where the local jurisdiction requires that certain construction be done by the utility in order to achieve a desired purpose of the government unit, *e.g.*, tearing up an old road to be replaced by a new one may require replacement of certain underground pipes and lines, providing additional sewage disposal facilities as a result of drainage projects, etc.

A qualified expenditure is an amount which is expended for the acquisition or construction of tangible capital assets,[1] where the acquisition or construction of the facility was the purpose motivating the contribution (*i.e.*, the purpose for which such amounts were collected). Such capital assets must be used predominantly (*i.e.*, 80% or more) in trade or business of furnishing water or sewerage services to the utility's customers. Such expenditure must occur by the end of the third taxable year after the year in which the money was received.[2] For this purpose, the committee intends that amounts received by the utility which are subject to being returned to the payer, if the cost of the facility is less than projected, are not subject to these rules so long as the repayment occurs within the 2-year period during which qualified expenditures can be made. Any amounts not so expended must be included in income for the taxable year in which such amounts were received. In addition, accurate records must be kept of the amounts contributed on the basis of the project for which the contribution was made and by year of contribution.

No depreciation may be claimed and no investment credit may be taken with respect to any property acquired as a result of a qualified expenditure.[3] If a taxpayer wishes to change its present practice of treating contributions in aid of construction to a practice which is consistent with this provision, such change constitutes a change in method of accounting.

In providing these special rules for water and sewage disposal companies, the committee intends that no inference should be drawn as to the proper treatment of such items by companies which are not water or sewage disposal utilities.

Effective date

This provision is to be effective for contributions made on or after February 1, 1976.

Revenue effect

This provision will reduce budget receipts by $13 million in fiscal year 1977, $11 million in fiscal year 1978, and $11 million in fiscal year 1981.

[1] For this purpose, a capital asset includes all expenditures which must be capitalized for such facilities under the normal rules of tax accounting (sec. 263).

[2] The expenditure also can occur anytime before the contribution in aid of construction is received. For example, if the utility installed a water main for a customer in 1977, amounts received as contributions in aid of construction in years after 1977 from the customer are not taxable to the extent that the utility had made previous qualifying expenditures or makes qualifying expenditures within the 2-year period.

[3] However, in the case of an "advance" (described in item number 3, above), the payments made by the utility to the developer would be considered as a capital expenditure in the year of payment. In such a case, the payment should be allocated proportionately to the basis of each of the various assets acquired with the original contribution. Where such assets are depreciable, the allocated payments would be depreciable over the remaining useful life of that asset.

23. Prohibition of Discriminatory State Taxes on Generation of Electricity (sec. 1323 of the amendment)

Present law

Federal statutes provide few limitations on the power of States to tax nondomiciliaries or to impose special taxes on goods or services produced in the taxing State for nondomiciliary use outside the taxing State.

However, Public Law 86–272[1] does establish certain minimum standards upon the power of a State to tax nondomiciliaries selling in the taxing State in interstate commerce. That Act did not affect the powers of States to tax goods or services produced within its boundaries for consumption outside its boundaries. Title II of the Act, however, also provided for further "studies of all matters pertaining to the taxation of interstate commerce. . . ."

Reasons for change

The committee has learned that one State places a discriminatory tax upon the production of electricity within its boundaries for consumption outside its boundaries. While the rate of the tax itself is identical for electricity that is ultimately consumed outside the State and electricity which is consumed inside the State, discrimination results because the State allows the amount of the tax to be credited against its gross receipts tax if the electricity is consumed within its boundaries. This credit normally benefits only domiciliaries of the taxing State since no credit is allowed for electricity produced within the State and consumed outside the State.[2] As a result, the cost of the electricity to nondomiciliaries is normally increased by the cost the producer of the electricity must bear in paying the tax. However, the cost to domiciliaries of the taxing State does not include the amount of the tax.

The committee believes that this is an example of discriminatory State taxation which is properly within the ability of Congress to prohibit through its power to regulate interstate commerce.

Explanation of provision

The committee amendment prohibits any State, or political subdivision of a State, from imposing a tax on or with respect to the generation of electricity for transmission in interstate commerce if the tax is discriminatory against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. A tax is considered discriminatory if it directly or indirectly results in the payment of a higher gross or net tax on electricity generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce.

This provision is not intended to prohibit, restrain, or burden any other State which currently imposes a nondiscriminatory tax on the generation of electricity.

This provision replaces the current Title II of Public Law 86–272, which is the title calling for further congressional studies. A number

[1] 86th Cong., 1st Sess., 73 Stat. 555 (1959).

[2] However, a credit for the amount of a tax on the production of electricity imposed by a second State is allowed against the first State's gross receipts tax if the electricity is consumed in the first State.

of studies of the problem of multistate taxation of interstate commerce have already been made by congressional committees, and the present Title II is not needed to authorize any additional studies that may be needed.

The House bill contains no similar provision.

Effective date

The prohibition of discriminatory taxes made by this amendment applies with respect to taxable years beginning after June 30, 1974.

Revenue effect

This provision will have no impact upon Federal revenues.

24. Deduction for Cost of Removing Architectural and Transportation Barriers for Handicapped and Elderly Persons (sec. 1324 of the bill and new sec. 190 and sec. 263 of the Code)

Present law

Under present law, there are no special provisions for the tax treatment of expenditures to remove architectural and transportational barriers to the handicapped and elderly. Generally costs incurred for the improvement of property used in a trade or business must be capitalized. Such improvements may be depreciated over their useful life, if the period is determinable.

Reasons for change

In spite of previous Federal legislation to contend with the problem of architectural and transportational barriers to the handicapped and elderly, such barriers remain widespread in business and industry. The committee believes that creating a tax incentive for a limited period could promote more rapid modification of business facilities and vehicles. In addition, the removal of barriers to the handicapped and elderly would increase their involvement in economic, social and cultural activities.

Explanation of provision

The committee amendment provides electing taxpayers with a tax incentive for the removal of architectural and transportational barriers to the handicapped and elderly. There is no similar provision in the House bill.

Under this amendment, an electing taxpayer may treat certain expenses for the removal of architectural and transportational barriers as deductible expenses in the year paid or incurred instead of capitalizing them. Deductible expenses are those paid or incurred in order to make more accessible to and useable by the handicapped and elderly any facility or public transportational vehicle owned or leased by the taxpayer for use in his trade or business. The maximum deduction for a taxpayer for any taxable year is $25,000.

In order to qualify for the deduction, the expenses must be for barrier removal in business facilities which meet standards set by the Administrator of the General Services Administration, the Secretary of Defense, and the Secretary of Housing and Urban Development under previous legislation.[1] Deductible expenses for barrier removal

[1] "An Act to insure that certain buildings financed with Federal funds are so designed and constructed as to be accessible to the physically handicapped," approved August 12, 1968 (82 Stat. 718; 42 U.S.C. 4151).

in public transportational vehicles must meet standards set by the Secretary of the Treasury in consultation with the Architectural and Transportational Barriers Compliance Board. The definition of an elderly person under this provision is age 65 or over, the normal retirement age.

The deduction is limited to a 3-year period in order that the Congress may review its cost effectiveness.

Effective date

The amendment applies to taxable years beginning after December 31, 1976, and ending before January 1, 1980.

Revenue effect

The amendment will result in a revenue loss of $11 million in fiscal 1977 and $10 million in fiscal 1978.

25. Publication of Statistics of Income (sec. 1325 of the bill and sec. 6108 of the Code)

Present law

The Secretary of the Treasury is directed under (sec. 6108 of the Code) to publish annually statistics compiled from tax returns, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions and credits and any other facts deemed pertinent and valuable.

Reasons for change

The statistics published by the Internal Revenue Service are an extremely valuable source of information for the analysis of tax policy. Generally, the Service has done an excellent job in computing and publishing their statistics.

In one respect, however, these statistics are misleading. They use "adjusted gross income" as the definition of an individual's income. This is a concept that is useful for purposes of computing the appropriate amount of income tax but is not a very good analytical measure of total income for purposes of determining a person's ability to pay income tax. This has led to considerable confusion about the extent to which high-income people are able to avoid paying income tax.

Adjusted gross income equals all gross income that is not specifically excluded from gross income minus (1) trade or business deductions (other than most such deductions by employees), (2) certain trade or business deductions of employees, (3) the deduction for one-half of long-term capital gains, (4) deductions for losses from the sale or exchange of property, (5) deductions attributable to rents and royalties, (6) the moving expense deduction, (7) deductions for contributions to individual retirement accounts, (8) deductions for contributions to H.R. 10 plans, and (9) certain other deductions.

Taxable income equals adjusted gross income minus itemized deductions (or, if the taxpayer so elects, the standard deduction) and the deduction for personal exemptions.

In recent years, the Internal Revenue Service has published statistics on the number of people with high adjusted gross incomes who pay no individual income tax. In 1974, for example, there were 244 people with adjusted gross income above $200,000 who paid no Federal income tax. There were 5 tax returns with adjusted gross income over $1 million and no tax liability.

The committee believes that it is important to publish statistics on the extent of tax avoidance by high-income people, but that the statistics currently being published are deficient in several respects.

First, while most itemized deductions are for personal expenses and should not, therefore, be deducted in measuring total income, some of them are business or investment expenses that should be deducted in properly measuring total income. The use of adjusted gross income as a measure of total income means that no itemized deductions are allowed. One example of such a deduction that should be allowed is investment interest and expense, at least to the extent it offsets investment income. Another example is the deduction for employee business expenses.

Second, some of the types of income that are specifically excluded from gross income should be included in a proper measurement of total income for purposes of estimating ability to pay taxes. These include, for example, interest on State and local government bonds and the first $100 of dividend income, both of which are tax exempt.

Third, some of the deductions allowed in arriving at adjusted gross income should not be deducted in defining a proper measure of total income. These include such items as the capital gains deduction and the deductions for contributions to individual retirement accounts and H.R. 10 plans.

The committee believes that the Internal Revenue Service should use the available data to obtain a more accurate estimate of how many high-income individuals are able to avoid paying income tax, what is the effective tax rate on the high-income group, and precisely what deductions are used by high-income people in avoiding tax. The committee amendment, therefore, instructs the Secretary of the Treasury to publish statistics on tax liability of high-income individuals, using a definition of income that more closely corresponds to a proper analytical measure of total income than does adjusted gross income.

Explanation of provision

The committee amendment instructs the Secretary of the Treasury to publish statistics on the tax liability of people with high total incomes. These statistics should include the number and average income of high-income people with no income tax liability (after credits); the specific deductions, exclusions and credits used by these people to avoid tax; the number of high-income individuals; and the total income and tax liability of the high-income group.

For this purpose, income should be defined in a way that more closely approximates a proper analytical measure of total income than does adjusted gross income. This new concept of income should be derived from information that is now required to be listed on the tax return; the committee does not intend to complicate further the income tax return by adding new lines that are unnecessary for tax collection and are only designed to serve a statistical purpose. Being derived only from items already appearing on the tax return, this new measure of income will not itself be a comprehensive measure; but it will be better than adjusted gross income.

The new measure of income should include at least the following two adjustments: First, adjusted gross income should be reduced by investment interest and expense to the extent that it does not exceed investment income. Second, the items of tax preference under the minimum tax that are exclusions from gross income or deductions in arriving at adjusted gross income should be added back to adjusted gross income. In addition, the Secretary may make other adjustments that he feels are appropriate in defining a more useful analytical measure of income, as long as these can be calculated from information appearing on the tax return.

26. Report on Tax Increase Resulting From Inflation (sec. 1326 of the bill)

Present law

Present law contains no provision dealing with any reports with respect to tax increases resulting from inflation.

Reasons for change

When tax rates are expressed in terms of fixed dollar amounts, inflation changes the rate at which a given real tax base is taxed. For example, because the personal exemption, the minimum and maximum standard deductions, the rate brackets, and other items are fixed dollar amounts, inflation causes an increase in the rate at which a given amount of real income is taxed. When a person's income increases at the same rate that prices are rising, he experiences no change in his real before-tax income; but his income taxes will rise at a faster rate than inflation, so that his real after-tax income will decline. There are similar increases in other taxes where rates are set in fixed dollar amounts, like the estate and gift taxes and the corporate income tax. In other cases, like the 4-cent-per-gallon gasoline tax and the alcohol and cigarette taxes, the real tax burden declines with inflation because the tax is per unit and not tied to the price. There is no change in the real burden of the social security tax because it is automatically adjusted for increases in wages.

The committee believes that the American people should be aware of how much their real tax burden increases each year simply as a result of inflation. It has, therefore, agreed to an amendment that requires the President to report each year on the tax increase caused by inflation.

Explanation of provision

The amendment directs the President, in his annual economic report to estimate the change in the real tax burden resulting from the effect of inflation in eroding the real value of fixed dollar amounts used in determining tax rates. The President is to estimate this tax change separately for the major sources of Federal revenue. This estimate is to be made for the previous calendar year, and the President is to make a projection of the inflation-induced tax change for the current calendar year.

Inflation causes two changes in the real tax burden. First, because tax rates are expressed in fixed dollar amounts, inflation changes the rate at which a given real tax base is taxed. This is the situation referred to above, the magnitude of which should be estimated by the President. Second, inflation distorts the appropriate measure of income from capital because the present income tax does not take account of the effect of inflation in eroding the real value of a given amount of wealth. Estimating the magnitude of this second inflation-induced tax increase is much more difficult, and presents more analytical problems; therefore, the committee does not want to burden the President with the requirement that this second effect be quantified. However, if the President feels capable of making an estimate of the increased real taxation of capital income caused by inflation, the committee feels that he should be encouraged to publish such an estimate as well.

N. CAPITAL GAINS AND LOSSES

1. Holding period and capital loss offset

The House bill increased the holding period defining long-term capital gains and losses from six months to one year, and it increased the amount of ordinary income against which capital losses can be deducted from $1,000 to $4,000. In each case, the change would have been phased in over a three-year period.

The committee decided to delete these provisions. It believes that the entire question of the taxation of capital gains and losses requires reexamination and that these specific changes should be considered in the context of this general review.

2. Capital Loss Carryover for Regulated Investment Companies (sec. 1401 of the bll and sec. 1212 of the Code)

Present law

Generally, corporations may deduct their capital losses against their capital gains and may carry back any excess capital losses 3 years and carry over any additional capital losses for up to 5 years. In this 3-year carryback and 5-year carryforward period, corporations may offset their net capital losses only against their capital gains in these years.

Regulated investment companies (mutual funds), however, may only carry over their net capital losses for 5 years and are allowed to carryback.

Reasons for change

Regulated investment companies are a way for relatively small investors to invest in common stock and other securities. Generally, when a regulated investment company distributes a substantial fraction of its income to shareholders, it is exempt from the corporate income tax. The general intent of Congress has been that the income from these investments should be treated as if the individual shareholders were investing directly in the securities that they own through the mutual fund.

In some respects, however, the law treats an individual who invests through a mutual fund more harshly than one who invests directly. Regulated investment companies can carry their capital losses forward for only five years, so unless they have capital gains in this period, the individual shareholders can lose the benefit of deducting these capital losses against capital gains received by the mutual fund. (When they sell their shares in the mutual fund, however, they may deduct any capital loss against other capital gains and a limited amount of ordinary income.) Individuals who invest in securities directly, however, are permitted an unlimited capital loss carryover and also may deduct capital losses against up to $1,000 of ordinary income each year.

Mutual funds are also treated more harshly than other corporations which, in addition to the 5-year carryover for net capital losses, also have a 3-year carryback for such losses. Since mutual funds distribute most of their capital gains currently, they could derive little benefit from the 3-year capital loss carryback even if it were extended to them. Thus, while corporations generally can net their capital gains and losses over a 9-year period, regulated investment companies are limited to a 6-year period. In view of this and since regulated investment companies are essentially conduits for their individual shareholders, the committee believes it is appropriate to extend the 5-year carryforward period for capital losses by 3 additional years.

Explanation of provision

The committee amendment extends the carryover period for regulated investment companies from five years to eight years.

Effective date

The eight-year carryover is to apply to loss years ending on or after January 1, 1970.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $12 million for fiscal year 1977, $21 million for fiscal year 1978, and $51 million for fiscal year 1981.

O. PENSION AND INSURANCE TAX PROVISIONS

1. Individual Retirement Account (IRA) for Spouse (sec. 1501 of the Bill and new sec. 221 of the Code)

Present law

Under present law, an eligible individual may deduct up to $1,500 a year or, if less, 15 percent of the compensation includible in gross income, for contributions to his own individual retirement account (IRA). The deduction is available to an eligible employee without regard to marital status. Therefore, if both spouses earn compensation, each may contribute up to 15 percent of their respective earnings to a separate IRA subject to the limitation of $1,500 per taxpayer. The same rule applies to couples who live in a community property state, because the community property laws of a state or other jurisdiction are not taken into account with respect to the retirement savings deduction.

Reasons for change

The law presently does not permit an employee to make deductible contributions to an IRA for the benefit of a spouse not working outside the home. Consequently a spouse not employed outside the home does not have equal access to a taxfree retirement program under present law. The committee believes that this is unfair to a spouse who receives no compensation but performs valuable household work.

In order to extend the benefits of an IRA to homemakers, the committee has added a provision which will permit an employee to set aside retirement savinges for the benefit of his spouse not working outside the home.

Explanation of provision

Joint tenancy.—Under the committee amendment, an eligible individual is generally allowed a maximum retirement savings deduction of up to $2,000 a year or 15 percent of his compensation includible in gross income, whichever is less, for his contributions to an IRA established for the benefit of himself and his spouse with no earnings. The IRA must be established in a form having the effect of a joint tenancy, with right of survivorship. If the employee makes a contribution to a joint IRA during a year he is not permitted to make contributions to separate IRAs for that year. Of course, an individual in a community property jurisdiction could establish an account in joint names out of community funds.

Separate accounts.—Alternatively, under the committee amendment, an eligible individual is allowed a maximum retirement savings deduction of the least of (a) $2,000, (b) 15 percent of the compensation includible in gross income, or (c) twice the lesser amount contributed on behalf of either spouse for contributions to two separate IRA's (one in the name of the taxpayer and the second in the name of the spouse with no earnings). For example, an individual with compensation of $20,000 who makes a contribution of $700 to the spouse's account and $600 to the taxpayer's account would be allowed a deduction of only $1,200. The excess contribution ($100) in the account to which $700 was contributed will be subject to a 6-percent excise tax payable by the spouse entitled to the deduction.

Other rules.—The expanded IRA rules will be available for a taxable year during which only one spouse is employed and the other spouse has no earnings and is not an active participant in tax-favored retirement plans or a government plan. For example, if a husband works all year, and his wife receives no compensation and is not an active participant in a plan at any time during the year, the expanded IRA rules will apply. If the spouses have different taxable years, the usual $1,500 IRA limit will apply (rather than the $2,000 limit), for example, to a contribution by the husband if his wife receives compensation during her taxable year ending with or within the taxable year of her husband. If both husband and wife receive compensation at any time during the taxable year, each can deduct contributions to an IRA under current law, if each is otherwise entitled to deduct such contributions. In addition no distribution could be made from a joint IRA during the joint lives of the husband and wife without the consent of both spouses.

Generally, rollovers would be permitted under the committee amendment in the same manner as under present IRA rules. For example, a rollover from a joint IRA to an IRA for the benefit of a spouse will preclude either spouse from making another IRA-to-IRA rollover within a three-year period. A rollover from a joint IRA would not be permitted to either spouse if either had made an IRA-to-IRA rollover within the preceding three years.

If a spouse rolls over distributions from one or more qualified plans to a joint IRA, the committee amendment does not allow a rollover from that IRA to another qualified plan unless (1) the other plan credits to that spouse the amount rolled over, and (2) the only contributions to the joint IRA consisted of the rollovers from qualified plans on behalf of that spouse.

Under the committee amendment, it is intended that the excess accumulation excise tax now applicable to IRA's will be paid by the elder spouse in the case of a joint IRA.

The House bill does not contain a comparable provision.

Effective date

The committee amendment applies to taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $3 million in fiscal year 1977, $21 million in fiscal year 1978, and $25 million in fiscal year 1981.

2. Limitation on Contributions to Certain H.R. 10 Plans (sec. 1502 of the bill and sec. 415 of the Code)

Present law

Under present law, a self-employed individual may set aside up to $750 a year of earned income as a deductible contribution to a tax-qualified "H.R. 10" plan, even though this amount exceeds 15 percent of his earned income (the regular deduction limit for H.R. 10 plans) because, under present law, a special limitation is provided which permits the deduction unless the contribution exceeds 100 percent of his earned income for the taxable year (sec. 404(e)(4)).

However, a separate code provision (sec. 415) limits the amount which may be set aside for the benefit of any participant under all tax-qualified defined contribution plans, including H.R. 10 plans, to no more than 25 percent of earned income. As a result, a self-employed individual earning less than $3,000 a year has been unable to take full advantage of the 100-percent limitation.

Reasons for change

The 100-percent limitation was enacted in order to enable certain organizations of the self-employed (such as the Jockeys' Guild) to set up retirement plans for their members without having to confront complex recordkeeping and administrative problems, and in order to allow any moderate or lower income self-employed individual who wishes to do so to save for his retirement. The 25-percent ceiling on allocations under defined contribution plans, however, has generally made the 100-percent limitation unavailable to its intended beneficiaries.

Explanation of provision

Under the committee amendment, the allowable annual addition to a self-employed individual's account under a defined contribution plan is not less than the minimum amount deductible under the $750 and 100-percent-of-earned-income rules, provided that the taxpayer's adjusted gross income for the taxable year does not exceed $15,000. The $15,000 limit insures that the provision is limited to its intended beneficiaries—low- and moderate-income taxpayers.

The House bill does not include a comparable provision.

Effective date

The committee amendment applies to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that the provision will result in a negligible decrease in tax liability.

3. Deduction for Retirement Savings of Government Employees (sec. 1503 of the bill and sec. 220 of the Code)

Present law

Under present law, employer contributions to a qualified pension, profit-sharing, stock bonus, or annuity plan on behalf of an employee are generally not includible in the employee's income until distributed or made available to the employee (secs. 402 and 403(a)). No deduction is allowed for employee contributions to such a plan. Additionally, amounts contributed by certain employers[1] for the purchase of a tax sheltered annuity on behalf of an employee are excludable from the employee's income, within limitations (sec. 403(b)).

[1] Charitable, and so forth, organizations described in section 501(c)(3) and certain educational institutions.

Further, under the Code, as amended by the Employee Retirement Income Security Act of 1974 (ERISA), contributions made by or on behalf of an individual to an individual retirement account (referred to as an "IRA") are deductible within limitations. The deduction allowed for a contribution made during a year is not to exceed the lesser of $1,500 or 15 percent of the individual's compensation included in gross income for the year (sec. 219).

No deduction is allowed to an individual for a contribution to an IRA during a year if, for any part of the year, he was an active participant in a qualified pension, etc., plan or in a governmental plan (whether or not qualified), or if, for any part of the year, amounts were contributed by his employer for a tax sheltered annuity.

If contributions are made in excess of the amount allowable as a deduction, an excise tax is imposed on the excess for each year it remains in the IRA (sec. 4973).

IRA's are supposed to be used for retirement purposes. Consequently, if a distribution is made from an individual's IRA before he attains age 59½, an additional 10-percent income tax is imposed on the IRA distribution, except in the case of death or disability (sec. 408(f)). Further, an excise tax is imposed where distributions do not commence by the close of the taxable year during which the individual attains age 70½. (The tax for a year is 50 percent of the excess of the amount required to be distributed from the IRA over the amount actually distributed in that year.)

Reasons for change

The House bill would (1) allow an active participant in a qualified plan or tax-sheltered annuity to make deductible contributions to an IRA, and (2) allow a participant active in a plan on the day ERISA was enacted to deduct employee contributions to that plan. Under these provisions of the House bill, the IRA limits on deductions would continue to apply, but they would be reduced by the amount of employer contributions allocable to the employee. These provisions of the House bill would not apply to an individual who participates in a governmental plan. The committee deleted this House bill provision.

If, however, the provisions of the House bill are eventually adopted, the committee believes that they should apply to government employees. Therefore, the committee has adopted provisions under which a participant in a government plan would be permitted to make deductible contributions to an IRA (but only if a provision like that in the House bill becomes effective). In the event the government employee-type IRA becomes effective, the IRA limits on deductions would continue to apply, but they would be reduced by the amount of employer contributions under the regular pension plan allocable to the employee.

Explanation of provision

Deduction allowed.—Under the committee amendment, an employee who is an active participant in a governmental plan (whether or not qualified) is to be allowed a deduction for contributions to an IRA. The provision will not apply, however, if the employee is also an active participant in a qualified nongovernmental plan or a tax sheltered annuity.

The deduction allowed is to be subject to the same limitations applicable to IRA contributions, except that the limitation is to be reduced by "qualifying employer contributions" under the governmental plan.

Under the committee amendment a participant in a governmental plan could make deductible contributions to an IRA for his spouse who is not employed outside the home if all requirements of the IRA rules are satisfied. (See *Individual Retirement Account* (*IRA*) *for Spouse.*)

In addition, the committee's amendment would extend the time for making deductible contributions to IRA's. Under the amendment, the time for making such a contribution is extended until the forty-fifth day after the close of the individual's taxable year. It is contemplated that this provision will be administered in a manner corresponding to a similar provision relatng to qualified plans (sec. 404(a)(6)).

Qualifyinng employer contributions.—Qualifying employer contributions are determined under both qualified and nonqualified plans. In the case of a defined contribution plan, if the employer contributions are discretionary, qualifying employer contributions are to be determined under Treasury regulations.

Under a defined contribution plan without discretionary employer contributions, the amount of the qualifying employer contributions is the sum of the employer contributions and forfeitures required to be allocated for the benefit of the individual under the plan for the year ending with or within the individual's taxable year.

In the case of a defined benefit plan, the qualifying employer contribution is an amount equal to the cost of the benefit provided for the employee, allocable to the year ending with or within the employee's taxable year.

This cost would be determined for all employees covered by a particular defined benefit plan under the individual level premium method. Generally, under this method, the cost for a year would be the level amount which, if contributed for each year of the employee's participation, would, with earnings, fund the amount of the employee's benefit under the plan.

Under the committee amendment, a participant in a governmental plan is not allowed a deduction for IRA contributions unless the method used by the plan to compute the qualifying employer contributions is acceptable to the Internal Revenue Service. It is anticipated that the Treasury Department will, by regulations, specify the particular actuarial assumptions which are to be used for this purpose.

It is expected that these regulations will also provide that, if a plan provides optional forms of benefits, the qualifying employer contributions are to be computed on the basis of the form having the greatest actuarial value. Under the committee amendment, ancillary benefits not taken into account under section 415(b)(1)(B) (other than joint and survivor annuities) will not be taken into account in computing qualifying employer contributions. In any case, the amount actually contributed to a plan would not be taken into account in computing qualifying employer contributions under a defined benefit plan.

The plan administrator of, or the employer maintaining, a governmental plan is to furnish a report to any active participant who requests it, showing the amount of qualifying contributions for that participant for the year. The request and reports are to be made at the time and in the manner required by Treasury regulations.

Effective dates

The committee amendment generally applies for taxable years beginning after December 31, 1976, but only if participants in nongovernment qualified plans are allowed a deduction for IRA contributions.

4. Retirement Deductions for Members of Armed Forces Reserves and National Guard (sec. 1504 of the bill and sec. 219 of the Code)

Present law

Under present law, an individual who is covered by a governmental plan is not allowed to make tax-deductible contributions to an individual retirement account (IRA).

Reasons for change

The rule prohibiting contributions to IRAs by a participant in a governmental plan denies IRA deductions to members of the National Guard and Armed Forces Reserves because they are covered by the U.S. military retirement plan. Generally, under this plan, members of the Reserves or Guard who serve for less than 20 years are not entitled to benefits. Consequently, many members of the Reserves or Guard are denied individual retirement account deductions even though they will not obtain benefits under the Government's plan.

Explanation of provisions

The committee amendment allows individual retirement account deductions for a year by a member of the Armed Forces Reserves or National Guard (who is otherwise eligible for the deduction) if his service for the year, excluding active duty for training, is less than 90 days. The House bill did not include a comparable provision.

Effective date

The amendment would apply for taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that this provision will reduce budget receipts by $5 million per year.

5. Tax-Exempt Annuity Contracts in Closed-End Mutual Funds (sec. 1505 of the bill and sec. 403(b)(7) of the Code)

Present law

Under present law, amounts contributed by certain tax-exempt employers for the purchase of an annuity contract (a tax-sheltered annuity) for an employee are (within limits) excluded from the gross income of the employee (sec. 403(b)). The tax-exempt employers to which this provision relates for the most part are religious, charitable and educational organizations and educational institutions operated by a State or local government.

Under a provision added to the Code by the Employee Retirement Income Security Act of 1974 (ERISA), amounts contributed by an employer for the purchase of stock of a regulated investment company which issues redeemable shares (an open-end mutual fund) in order to provide a retirement benefit for an employee are treated as amounts paid for the purchase of a tax sheltered annuity (sec. 403 (b)(7). However, amounts contributed by an employer for the purchase of stock in a regulated investment company which does not issue redeemable shares (a closed-end investment company) do not qualify for treatment as amounts paid for the purchase of a tax sheltered annuity.

Reasons for change

Closed-end investment companies are regulated investment companies subject to the same regulation by the Securities and Exchange Commission and the Internal Revenue Service as are open-end funds, and they similarly offer professional asset management of a diversified investment portfolio. In addition, a closed-end investment company can offer a retirement benefit by providing a stock disposition arrangement under which stock is sold by the company on behalf of the shareholder on a monthly basis without commissions and the proceeds are remitted to the shareholder at a nominal charge. Such an arrangement is similar to the stock redemption arrangements offered by certain open-end mutual funds. Consequently, the exclusion of closed-end investment companies which provide retirement benefits under these rules does not appear to be appropriate.

Explanation of provision

The amendment would permit an investment in stock of a closed-end investment company to qualify for treatment as a tax-sheltered annuity by deleting the provision in present law that limits qualifying investments in regulated investment companies to investments in those which only issue redeemable stock.

Effective date

This amendment would apply to taxable years beginning after December 31, 1975.

Revenue effect

It is estimated that the revenue effect of this provision will be negligible.

6. Pension Fund Investments in Segregated Asset Accounts of Life Insurance Companies (sec. 1506 of the bill and secs. 401 and 801 of the Code)

Present law

Under present law, a life insurance company may base its reserve for certain annuity contracts (e.g., variable annuity contracts) on a segregated asset account. Accordingly the amounts paid in or paid out under the contract vary with the performance of the assets held under the account. Under the Code, the income, expenses, gains, and losses with respect to assets held under a segregated asset account under a contract for a qualified pension plan are generally not considered income, etc. of the life insurance company.

Reasons for change

Under present law, a segregated asset account may not be used by a life insurance company except as the basis for a contract which provides for the payment of annuities. The Internal Revenue Service has taken the position that a segregated asset account can be used as the basis for a reserve for a contract by a particular life insurance company only if that life insurance company provides annuities under the contract. Therefore, an employer who wishes to have its qualified pension fund invested in a segregated asset account held by a particular life insurance company but wishes to purchase annuities from another life insurance company (or to provide annuity benefits directly from an employee trust) is unable to do so without incurring the cost of compensating the holder of the account for annuity purchase rate guarantees that will not be utilized. This cost is unnecessary and would not be incurred in these circumstances if the holder of the account were not required by the tax law to provide annuity contracts with respect to the account.

Explanation of provision

The committee amendment clarifies present law by providing that a segregated asset account can be used as an investment medium for assets of a qualified pension, profit-sharing, or annuity plan even though the account is held as a reserve under a contract which does not require the holder of the account to provide for the payment of annuities. The committee amendment also permits assets of a qualified plan to be held in a segregated asset account instead of a trust. The amendment does not in any way modify the requirements of title I of the Employee Retirement Income Security Act which requires certain pension plan assets to be held in a trust.

The House bill contains no comparable provision.

Effective date

The committee amendment applies for taxable years beginning after December 31, 1975.

Revenue effect

The revenue effect of this provision is expected to be negligible.

7. Extension of Study of Salary Reduction and Cash or Deferred Profit-Sharing Plans (sec. 1507 of the bill)

Present law

Under present law, in general, an employee's contributions to a tax qualified retirement plan maintained by his employer are not tax deductible. In the case of a salary reduction plan, or a cash and deferred profit-sharing plan, however, the Internal Revenue Service has permitted employees to exclude from income certain amounts contributed by their employers to the plan, even where the source of these amounts is the employee's agreement to take salary or bonus reductions, or forego salary increases.

On December 6, 1972, the Service issued proposed regulations which would have changed this result in the case of salary reduction plans, and which called into question the continued viability of the treatment of cash and deferred profit-sharing plans.

In order to allow time fon congressional study of these areas, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, contributions to plans in existence on June 27, 1974, are governed under the law as it was applied prior to January 1, 1972 and this treatment is to continue at least through December 31, 1976, or (if later) until regulations are issued in final form in this area, which would change the pre-1972 administration of the law. Section 2006 of ERISA provides that these regulations, if issued, are not to be retroactive for purposes of the social security taxes or the Federal withholding taxes, and are not to be retroactive prior to January 1, 1977, for Federal income tax purposes.

In the case of plans not in existence on June 27, 1974, contributions made on a salary reduction basis, or made, at the employee's option, to a cash and deferred profit-sharing plan, are treated as employee contributions (until January 1, 1977, or until new regulations are prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law while Congress has not yet determined what the law should be in the future.

Also to be covered under these principles are so-called "cafeteria plans," under which the employees may have a choice between certain fringe benefits, some of which would constitute taxable income to the employee, whereas other forms of benefit might not. Thus, cafeteria plans in existence on June 27, 1974, also are governed under the pre-1972 law until at least January 1 1977. However, in the case of new plans, the value of any benefits selected under a cafeteria plan are to be includable in income until at least January 1, 1977 (or, if later, until new regulations in this area have been promulgated). In general, the same rules to be applied in determining whether or not a salary reduction plan was in existence on June 27, 1974, are also to be applied to cafeteria plans. Of course, minor plan amendments (such as changing the plan to allow cash payments to cover cases of breakage, i.e., where two alternative benefits available under the cafeteria plan do not have exactly the same value) would not cause an existing plan to be classified as a new plan for purposes of these rules.

Reasons for change

The committee believes it is not possible to study adequately the questions involved in order to enact permanent legislation regarding salary reduction and cash and deferred profit-sharing plans prior to the January 1, 1977 end of the temporary freeze of the status quo provided for in section 2006 of ERISA. The committee therefore decided to extend the time for the congressional review of the treatment of these plans.

Explanation of provision

In order to allow additional time for congressional study of these areas, the committee amendment would extend the temporary freeze from January 1, 1977, until January 1, 1979.

The committee amendment is effective on the date of enactment of the Act.

8. Consolidated Returns for Life and Mutual Insurance Companies (sec. 1508 of the bill and sec. 1504 of the Code)

Present law

Under present law, life insurance companies, both stock and mutual, (taxed under section 802 of the code and hereafter referred to as life companies) are barred from filing consolidated income tax returns with corporations that are not life companies. A similar restriction applies to mutual insurance companies other than life companies (taxed under section 821 of the code and hereafter referred to as "other mutual insurance companies). On the other hand, stock property-liability insurance companies (and certain other companies) taxed under section 831 of the code are generally permitted to file consolidated returns with other types of corporations.

Reasons for change

The present ban on life companies filing consolidated returns with other companies historically has been based on the fact that life insurance companies have been taxed quite differently from other companies. In their case, Congress has been concerned that in any event a tax should be imposed, at the regular rate, on an amount approximately equal to their taxable investment income. For this reason, for example, limitations were imposed on the extent to which policyholder dividends could in effect reduce taxable investment income. As a result, Congress in the past has not allowed life insurance companies to file consolidated returns with other types of companies and in this manner offset their taxable investment income against losses realized from other types of operations.

It is recognized, however, that consolidated returns and offsets of losses are allowed in the case of many diverse types of businesses under present law, some of which are subject to special tax provisions. Moreover, it is recognized that the recent recession and inflation in prices has caused many casualty insurance companies to incur large losses. If a stock casualty company and a noninsurance company are affiliated, they can file a consolidated return on which the losses of the casualty company are applied against the other company's profits. However, if the other company is a life insurance company, the losses of the casualty company can only be applied against the casualty company's income for other years (by means of loss carryovers and carrybacks); they cannot be applied against the life company's income. Consequently, the present ban on life-nonlife consolidations has been a hardship for casualty companies which are affiliated with life companies.

The committee amendment deals with this problem by permitting consolidated returns to be filed by life companies and nonlife companies, subject to the restrictions that (1) the life company's taxable income cannot be reduced by more than one-half as a result of the consolidation, and (2) no more than one-half of a nonlife company's losses can be applied against a life company's income in any year. Any nonlife company losses not absorbed in this manner will still be available as carryovers of the nonlife companies to subsequent years. This preserves the concept sought by Congress in the past to the effect that some tax will be paid with respect to the life insurance company's investment income (except where the company itself has an overall loss from operations), but at the same time provides substantial relief in the future for casualty companies with losses.

Explanation of provision

As indicated above, the committee amendment allows mutual or stock life companies and other mutual insurance companies to elect to join in the filing of consolidated returns, with other types of corporations which are under the same common control and which meet the stock ownership requirements of an "affiliated group." Consolidations of life and nonlife companies however, would be subject to certain limitations as to the extent of the loss offsets as indicated below.. The filing of a consolidated return by an affiliated group which includes a life company and a property-liability company will permit the tax savings from the property-liability company's losses to be taken into account sooner in computing its statutory surplus. This larger surplus should increase the capacity of these companies to write insurance. There is no comparable provision in the House bill.

Election.—Under regulations prescribed by the Treasury Department, the amendment provides that the common parent of an affiliated group which includes a life company or other mutual insurance company may elect to include such a company in the filing of a consolidated return with other corporations for any taxable year beginning on or after January 1, 1978. Once this election is made, all insurance companies in the affiliated group, as well as other members of the group, must continue to file consolodated returns unless the group obtains the right to revoke its election under the applicable Treasury Department regulations. If this election is not made, existing law will continue to apply. That is, in such cases the life and other mutual insurance companies will continue to be treated as "nonincludible" corporations, but under present law two or more life companies (which meet the definition of an "affiliated group") may still continue to file a consolidated return with each other.

It is understood that although generally companies will probably desire to file consolidated returns with the life or other mutual insurance companies, some may choose to continue to file separate returns under existing law. Where this occurs, it is likely to arise from the fact that the parent corporation (whose year the other members joining in the filing of the consolidated return must follow) uses a fiscal year as its taxable year. Some life companies may not want to adopt a taxable year other than a calendar year since filings with State insurance commissioners are required by these life companies on a calendar year basis.

To facilitate the filing of consolidated returns with life companies where the common parent has a fiscal year, the committee amendment waives in this case the general requirement of the tax law (sec. 843 of the code) that insurance companies must use the calendar year as their taxable year. However, the use of a fiscal year by an insurance company is not intended to affect the applicable method of accounting required of the insurance company by the tax law (subchapter L). In this case it is expected that the regulations will require the insurance companies to maintain adequate records reconciling all of the items on its fiscal year tax return with the corresponding items on its calendar year statements filed with the State insurance commissioners.

50-percent limitation on certain losses.—For reasons previously indicated, the committee amendment imposes limitations on the amount of consolidated net operating loss which can be applied against the income of a life company. Under the limitations, the amount of the loss which may be taken into account in any one year is limited to 50 percent of the taxable income of the life companies included in the group or to 50 percent of the sum of the losses for the current year and for prior years, whichever is less. The taxable income of each life company for this purpose is its "life insurance company taxable income" (as defined in sec. 802(b) of the code), but determined without regard to its so-called phase III income. Any portion of a loss which is not taken into account because of the limitations may be offset against the income of a life company member as a carryforward, but not as a carryback).

The limitations outlined above can be illustrated by an example. Assume a life insurance company has a subsidiary which (1) is not an insurance company, and (2) incurs a net operating loss of $120 in 1979 ($20 of which is absorbed by a carryback against the subsidiary's own prior year's income). Assume further that the parent company's life insurance company taxable income for 1979 (determined without regard to its phase III income under sec. 802(b)(3)) is $150. The amount of the subsidiary's loss which can be applied against the parent's income for 1979 is $50 (one-half of the available loss), since this is less than one-half of the parent's income for the year. If in 1980 the subsidiary has a net operating loss of $60 and the parent has income of $200, the amount of the loss offset for 1980 would be $55 (one-half of the sum of the current year's loss and the loss carryover). The losses which can be carried over to subsequent years in this case follow the usual rules applicable to the absorption of loss carryovers so that, for example, the loss carryover to 1981 would consist of a $50 loss from 1979 and a $5 loss from 1980.

If in the above example the parent had $80 of income in 1980 (rather than $200), the amount of the loss offset for that year would be limited to $40 (one-half of the parent's income for the year) which is less than $55.

Other rules.—Under the committee amendment the details of the computation of the tax liability of an affiliated group which includes life or other mutual insurance companies is to be determined under regulations issued by the Treasury Department. Also, an election to consolidate life and nonlife companies cannot be revoked without the consent of the Internal Revenue Service. This is the same approach as is generally taken under present law with respect to other affiliated groups.

For other mutual insurance companies included in the affiliated group and included in consolidated returns, the committee amendment requires that the regular normal corporate tax rates apply rather than the special rates provided for small companies.

Another special rule makes it clear that the enactment of the new provisions is not to result in the termination of an affiliated group. For example, assume that a life company owns 100 percent of a subsidiary which in turn owns 100 percent of a second subsidiary. Assume further that the first and second subsidiaries are not life companies but elect to file consolidated returns under this provision. If the life company also elects to join in the filing of a consolidated return, then the affiliated group of the two subsidiaries would not be treated as having been terminated (as a result, any deferred intercompany transactions between the subsidiaries would not be treated as giving rise to taxable income).

Effective date

The committee amendment is effective for taxable years beginning after December 31, 1977. However, a transitional rule is provided to limit the use of carryovers of losses and credits for pre-1978 years. These carryovers are to be treated as if the committee amendment had not been made. This means that the ability to absorb these losses or credits is not to be changed as a result of the new election to include life or other mutual insurance companies in a consolidated return with other companies. The same principles also apply with respect to losses and credits which may be carried back to pre-1978 years.

To illustrate this rule, assume that a noninsurance company owns both another noninsurance company and also a life company. Assume that the two noninsurance companies presently file consolidated returns. If this affiliated group has consolidated net operating losses in 1977 which can be carried to 1978, even though an election is made for 1978 to include the life company in the consolidated return, the absorption of this loss is to be determined as if the new consolidation rules do not apply. This means that the life company's profits are not to be available to offset any part of this carryover loss. In addition, if in 1978 the parent noninsurance corporation were to acquire a profitable property-liability company (or other company not directly affected by the new rules) and under normal consolidated return rules these profits could be utilized in determining how much of the 1977 loss could be absorbed, the use of these profits in this manner would not be affected by the new rules. However, if the life company were to acquire this profitable corporation, its profits would not be available to offset the noninsurance company 1977 loss, since the profitable member in this case would be a subsidiary of the life company and would not be treated as a member of the nonlife insurance group under present law.

Revenue effect

It is estimated that this provision will result in a decrease in revenues of $25 million in the fiscal year 1978, $55 million in the fiscal year 1979, $49 million in the fiscal year 1980, and $40 million in the fiscal year 1981.

9. Treatment of Returned Inadvertent Distributions of Life Insurance Companies (sec. 1509 of the bill and sec. 815 of the Code)

Present law

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

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

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

Reasons for change

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

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

The Internal Revenue Service has interpreted present law to require a life insurance company to pay the phase III tax on a wholly unintentional distribution out of the policyholders surplus account even though the shareholders of the company promptly return the distribution upon learning of the error, and even though the company has a long-standing policy of limiting its distributions to stockholders to amounts in the shareholders surplus account and footnoting its

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

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

published financial statements with a statement that the company has "no present plans for distributing the amounts in policyholders surplus". Under this interpretation, amounts distributed out of the policyholders surplus account by mistake are held subject to the phase III tax even though they were restored to the company before its return for the year was due.

Explanation of provision

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

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

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

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

The committee amendment would provide relief for the Business Men's Assurance Company of America (BMA) with respect to a distribution made in December 1969. The amount of money involved in the inadvertent BMA distribution was nearly $5.5 million. In this case, the principal shareholder of the company promptly returned the distribution upon learning of the error.

The House bill contained no comparable provision.

Effective date

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

Revenue effect

Other than the revenue loss involved with respect to BMA (approximately $6 million for 1976), the committee amendment is not expected to have any significant effect on the revenues in the future.

10. Guaranteed Renewal Life Insurance Contracts (sec. 1510 of the bill and sec. 809(d)(5) of the Code)

Present law

Under present law, a life insurance company is allowed a deduction equal to 10 percent of the increase in its reserves for nonparticipating contracts for a taxable year or, if greater, an amount equal to 3 percent of the premiums for the year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of five years or more.

Reasons for change

Controversy has arisen where, for example, a one-year nonparticipating term life insurance policy is guaranteed by the life insurance company to be renewable by the policyholder for five years. The Internal Revenue Service has contended that because such a policy is issued and renewed for a one-year period, the deductions for nonparticipating policies is not allowable. Taxpayers have contended that because of the five-year renewable right, the policy should be treated as a five-year policy and that the deduction is therefore allowable.

Explanation of provision

The committee amendment resolves the present controversy by providing that the period for which a contract is issued or renewed includes the period for which the contract is guaranteed renewable. No comparable provision is included in the House bill.

Effective date

Since the committee has concluded that it was the intent of Congress in the Life Insurance Company Income Tax Act of 1959 to treat guaranteed renewable contracts in the same manner as noncancellable contracts, it believes it is appropriate to resolve the controversy for past as well as future years. The committee amendment, therefore, is effective as of the general effective date of the Life Insurance Company Income Tax Act of 1959; that is, it will apply to taxable years begining after December 31, 1957.

Revenue effect

The revenue effect of the committee amendment is expected to be negligible.

P. REAL ESTATE INVESTMENT TRUSTS

Present law

Under present law, real estate investment trusts ("REITs") are provided with the same general conduit treatment that is applied to mutual funds. Therefore, if a trust meets the qualifications for REIT status, the income of the REIT which is distributed to the investors each year generally is taxed to them without being subjected to a tax at the REIT level (the REIT being subject to tax only on the income which it retains and on certain income from property which qualifies as foreclosure property). Thus, the REIT serves as a means whereby numerous small investors can have a practical opportunity to invest in the real estate field. This allows these smaller investors to invest in real estate assets under professional management and allows them to spread the risk of loss by the greater diversification of investment which can be secured through the means of collectively financing projects.

In order to qualify for conduit treatment, a REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow the special tax treatment for a REIT only if there really is a pooling of investment arrangement which is evidenced by its organizational structure, if its investments are basically in the real estate field, and if its income is clearly passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the income of the REIT must be passed through to its shareholders on a current basis.

With respect to the organizational structure, a REIT, in general, must be an unincorporated trust or association (which would be taxable as a corporation but for the REIT provisions) managed by one or more trustees, the beneficial ownership of which is evidenced by transferable shares or certificates of ownership held by 100 or more persons, and which would not be a personal holding company even if all its adjusted gross income constituted personal holding company income.

With respect to the income requirements, at least 75 percent of the income of the REIT must be from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (or interests therein, including mortgages), distributions from other REITs, gain from the disposition of shares of other REITs, abatements or refunds of taxes on real property and income and gain derived from property which qualifies as foreclosure property. An additional 15 percent of REIT income must come from these sources, or from other interest, dividends, or gains from the sale of stock or securities. Income from the sale or other disposition of stock or securities held less than 6 months, or real property held less than 4 years (except in the case of involuntary conversions), must be less than 30 percent of the REIT's income.

With respect to the asset requirements at the close of each quarter of its taxable year, a REIT must have at least 75 percent of the value of its assets in real estate, cash and cash items, and Government securities. Furthermore, not more than 5 percent of the REIT's assets can be in securities of any one nongovernment-non REIT issuer, and such holdings may not exceed 10 percent of the outstanding voting securities of such issuer. Also, no property of the REIT, other than foreclosure property, may be held primarily for sale to customers.

In addition, a REIT is required to distribute at least 90 percent of its income (other than capital gains income, and certain net income from foreclosure property less the tax imposed on such income by section 857) to its shareholders during the taxable year or, under certain circumstances, the following taxable year. If all of these conditions are met, then the REIT generally is qualified for the special conduit treatment which allows the income that is distributed to the shareholders to be taxed to them without being subjected to a tax at the trust level, so that the REIT is only taxed on the undistributed income and certain income from foreclosure property. A REIT that does not meet the requirements for qualification would be taxed as a regular corporation.

Reasons for change

Although the provisions have been amended from time to time, until 1974 the basic rules with respect to REITs have remained the same since their enactment in 1960. Since 1960, the REIT industry has grown enormously in size and is responsible for a large portion of the investment in the real estate field in the United States today. There are, however, certain problems that have arisen with respect to the REIT provisions which could significantly affect the industry if these provisions are not modified.

In 1974, as part of Public Law 93–625, the Congress dealt with one of these problems, i.e., the difficulty which a REIT may have in meeting the income and asset tests if it must foreclose on a mortgage that it owns or reacquire property which it owns and has leased. Under that Act, in general, a REIT is not disqualified because of income it receives from foreclosure property, since acquisition of property on foreclosure generally is inadvertent on the part of the mortgagee. At the election of a REIT, a two-year grace period (generally subject to two one-year extensions) is allowed so that the REIT can liquidate the foreclosed property in an orderly manner or negotiate changes, *e.g.*, in leases on the property so that income from the property becomes qualified. However, during the grace period the REIT must pay the corporate tax on the otherwise nonqualified income received from property acquired on foreclosure.

Certain other problems remain in this area, however. Basically, these problems relate to the fact that, under present law, 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 test 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. The committee believes that it is not appropriate to disqualify a REIT in such circumstances.

Explanation of provisions

1. Deficiency Dividend Procedure (sec. 1601 of the bill and sec. 859 of the Code)

As described above, under present law, to qualify as a REIT a trust must operate as a conduit of the income it earns, distributing at least 90 percent[1] of its annual income to its shareholders. However, even where a REIT believes in good faith that it has satisfied this test, it may be disqualified as a result of an audit by the Internal Revenue Service which increases the amount of income that forms the base for the 90 percent distribution requirement. For example, a REIT's depreciation allowance for an asset may be nuclear (e.g., because of a problem in determining the useful life of an asset or in allocating the cost of rental property between land and improvements) and the depreciation taken by the REIT may be determining to be too high by the Internal Revenue Service in a subsequent year. In such a case, the REIT may lose its qualification if its real estate investment trust taxable income is increased to such an extent that its previous dividend distributions for the year in question become less than 90 percent of its real estate investment trust taxable income as determined after audit. On disqualification as a REIT, the trust would be subject to tax as any other corporation, even though it previously may have distributed most of its income for the year in question to its shareholders.

The committee believes that where a REIT originally acted without fraud in determining and reporting its income and dividend distributions, the sanction of disqualification is too severe. For this reason, the committee believes that if a REIT is audited by the Internal Revenue Service, and there is a resulting adjustment that would increase the amount of dividends that must be paid for the year under audit for the trust to meet the 90 percent distribution requirement, the trust should be allowed to pay out deficiency dividends to its shareholders and thereby avoid disqualification. This deficiency dividend procedure is only to be available where failure of the REIT to meet the 90 percent distribution requirement was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time.

The committee amendment provides that where, as a consequence of an audit by the Internal Revenue Service, there has been a “determination” that an adjustment is to be made, the trust may pay a deficiency dividend to its shareholders and receive a deduction for such distributions. If the proper amount is distributed as a deficiency dividend, the REIT would not be disqualified or be subject to tax on the amounts distributed (other than interest and penalties, as described below).[2]

[1] As described below, the committee amendment increases the distribution requirement to 95 percent for taxable years beginning after December 1, 1979. In this explanation, the requirement is referred to as the “90 percent distribution requirement”.

[2] Following the personal holding company provisions of present law, the bill provides that a “determination” is to be a decision by the Tax Court (or order by any other court of competent jurisdiction) which has become final, a closing agreement under section 7121, or an agreement (under regulations) between the Internal Revenue Service and the trust regarding the liability of the trust for tax.

For these purposes, an "adjustment", which will allow a REIT to follow the deficiency dividend procedure, is defined under the committee amendments to include an increase in the sum of the REIT's real estate investment trust taxable income (determined without regard to the deduction for dividends paid) and the net after-tax income from foreclosure property. An "adjustment" also is defined to include any decrease in the deduction for dividends paid (determined without regard to capital gains dividends). Any change on audit in these amounts either may increase the amount of dividends that must be paid to meet the 90-percent distribution requirement or may decrease the amount of dividends previously thought to have been paid, affecting the ability of the REIT to meet the distribution requirement.[3]

Such an increase in income, etc., need not cause the REIT to fail the 90-percent distribution requirement for the deficiency dividend procedure to be available. The deficiency dividend procedure also is to be available to enable a trust to maintain the level of distribution that it originally had thought it had achieved. On the other hand, a deficiency dividend cannot exceed the net adjustment that occurs on audit.

Assume, for example, that a REIT reported real estate investment trust taxable income of $100 for the year, and had distributed dividends of $90 with regard to that year, but on audit it was determined that the REIT had $110 of real estate investment trust taxable income for that year. In this case, the REIT could pay a deficiency dividend of up to $10, which is the amount of the adjustment, though only a $9 deficiency dividend would be required to enable the REIT to meet the income distribution requirements for that year. Thus, the REIT could pay a deficiency dividend sufficiently large so it would not have to pay any additional corporate income tax (as opposed to interest and penalties) as a result of the determination. However, the REIT could not receive a deficiency dividend deduction for $11 since this is greater than the amount of the adjustment, and would decrease the corporate tax previously paid on the $10 originally reported and treated as taxable.[4]

Capital gains.—Under present law, a REIT must pay a capital gains tax on any excess of net long-term capital gains over the sum of net short-term capital loss and the deduction for capital gains dividends paid to its shareholders. It is also required that capital gains dividends be designated as such within 30 days after the close of the taxable year in which the income is recognized. Consequently, if it is determined on audit that a REIT had additional capital gains, the REIT would not be able to make a timely designation of a capital gains dividend, distribute this income, and avoid paying capital gains tax. Also, even if the REIT had previously reported this income

[3] In addition, if on audit it is determined that there is an increase in the net long-term capital gains over net short-term capital loss and over the deduction for capital gains dividends, this increase will be an adjustment for purposes of the capital gains rules of the REIT provisions, as discussed below.

[4] Also, if this REIT had originally paid out a dividend of $99, it would be able to pay a deficiency dividend of up to $10, for a total distribution of up to $109. In this way, the REIT would not be subject to tax on additional income determined on audit. However, in this case, the REIT would not have to pay any deficiency dividend to avoid disqualification since it still would have met the 90-percent distribution requirement even after the adjustment, and, therefore, may choose not to pay any additional amounts under the deficiency dividend procedure.

as ordinary income and distributed 90 percent of it as dividends to shareholders, the REIT still would be subject to capital gains tax on this amount upon a determination that the income was capital gains (since a timely designation of capital gains dividends could not be made).

To correct this situation, the committee amendment provides that an "adjustment" which will allow the deficiency dividend procedure to be used is to include an increase (by a determination) in the excess of the net long-term capital gains over the sum of the net short-term capital loss and the deduction for capital gains dividends paid. Therefore, if net long-term capital gains increase as the result of an audit, the REIT can choose to distribute up to the amount of this increase to its shareholders and avoid paying capital gains tax on this amount. Also, if the REIT had originally reported this amount as ordinary income and previously had made a timely distribution of this income, the REIT is to be able to redesignate the previous distribuiton as a capital gains distribution, and avoid paying the capital gains tax.

In order to preserve administrative simplicity of the tax law in this area, the House bill provides in effect that a redesignation of a prior ordinary income distribution as a capital gains distribution (or vice versa) did not affect the shareholders' prior tax treatment of this distribution. The committee believes that ignoring the tax effects of a redesignation at the shareholder level is not proper so long as the statute of limitations has not expired and, consequently, has deleted the House provision which prevents recharacterization to the shareholders by reason of the deficiency dividend procedure. In addition, the committee has amended the House bill to clarify that the deficiency dividend will be treated as a dividend by both the trust and the shareholder even though the trust does not have sufficient earnings and profits at the time of the distribution.

Fraud.—Under the committee amendment, the deficiency dividend deduction is to be available only if the entire amount of the adjustment was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time. The House bill provides that the deficiency dividend procedure would be available only if the entire amount of the adjustment was due to reasonable cause. The committee believes, however, that the fraud standard is more appropriate in this area, because the interest and penalty provisions discussed below will be sufficient to encourage current distributions in the usual case. Under the committee amendment, the question of whether the failure to meet the dividend distribution requirement is due to fraud will depend on all the facts and circumstances.

Interest and Penalties.—The interest and penalty provisions of the committee amendment with respect to deficiency dividends are designed to recover lost revenues to the government as well as to assure that a REIT (1) will be operated as a conduit of income to its shareholders and (2) will not reduce its distributions of income in reliance on the availability of the deficiency dividend procedure. Under the committee amendment, interest and penalties are determined with respect to the amount of the adjustment,[5] but only to the extend that

[5] For this purpose, the amount of the adjustment would include adjustments attributable both to ordinary income and capital gains. However, no interest and penalty are assessed in the event of the late designation of a capital gains dividend where the amount was distributed previously as an ordinary income distribution.

the deficiency dividend deduction is allowed. For example, assume that the REIT's real estate investment trust taxable income was reported at $100, that the REIT had distributed $98, and that after audit it was determined that the correct amount of real estate investment trust taxable income was $120 so that the REIT should have distributed at least $108. If the REIT utilizes the deficiency dividend procedure and distributes an additional $10, the interest and penalty will be based upon $10, the amount for which a deficiency dividend deduction is allowed.

Under the House bill, the amount of the interest and penalty is based upon the total amount of the adjustment even though the REIT did not distribute the full amount of the adjustment under the deficiency dividend procedure. The committee believes it would be unfair to impose interest and a penalty on an amount larger than the REIT distributed under the deficiency procedure and, consequently, has amended the House bill accordingly.

By using the amount of the deficiency dividend as the base, the committee amendment assures that the net cost to the REIT of borrowing money from its shareholders (that is, the net cost of underdistributions) is high enough to discourage such action and to encourage the distribution of earnings to shareholders currently.

Under the committee amendment, interest on the amount of the deficiency dividend is to run from the last day (without extension of time) for the REIT to file a tax return for the year in question until the date the claim for the deficiency dividend deduction is filed. In addition, a nondeductible penalty equal to the amount of interest is to be paid. However, the total penalty is not to exceed one-half the amount of the deficiency dividend deduction.[6] Under the committee amendment, the (deductible) interest charge is to be the same as in the case of other deficiencies and the penalty is to be the same amount, for an approximate net-after-tax total of 1C½ percent of the deficiency dividend deduction per annum.

Effect on other years.—The committee amendment provides that the amount of the deficiency dividend is taxable to the shareholder for the shareholder's taxable year *in* which the distribution is made (not the year *for* which it is made). For example, if a shareholder receives a deficiency dividend in 1980, with respect to the year 1977, this dividend is includible in income for 1980, and shareholders are not to file amended returns for 1977 to take account of the dividend. It is expected that, in this case, the deficiency dividend will be paid to the 1980 shareholders, even if they were not shareholders in 1977.

To avoid double counting, deficiency dividends are not to count toward the dividends paid deduction for the year in which the deficiency dividends are actually paid, but are only to count toward the year affected by the determination. Also, deficiency dividends are not to count toward the dividend deduction (under section 858) for the taxable year preceding the year of payment. For example, if $10 of deficiency dividends are paid in 1980 on account of a determination involving the year 1977, the deficiency dividends are not to count

[6] Under the bill payment of the penalty portion decreases the base for the 90-percent distribution reqirement in the year the interest and penalty are paid. The interest portion is automatically takan into account in computing the base since it is deductible.

toward the dividends paid deduction for 1980 or for 1979, but are to be treated only as dividends paid with respect to 1977.

The House bill contains the same provision.

Technical requirements.—For the deficiency dividend deduction to be available, the trust must pay the deficiency dividend to its shareholders within 90 days after the determination. To qualify as a deficiency dividend, the dividends paid must be of the same type that would qualify for the dividends paid deduction under section 561, if they had been distributed during the taxable year in issue. Also, the trust must (under regulations) file a claim for the deduction within 120 days after the determination. (These provisions are similar to the provisions of existing law with respect to personal holding company deficiency dividends.)

Under the committee amendment, a REIT will have two years after the date of a determination to file a claim for refund for the taxable year in issue where allowance of a deficiency dividend results in an overpayment of tax. Also, if a REIT files a claim for a deficiency dividend deduction, the running of the period of limitations for making assessments, bringing a suit for collection, etc., is to be suspended for two years after the date of the determination.

Where there is a determination of a deficiency under these provisions, collection, interest, penalties, etc., are to be stayed for 120 days after the determination (except in cases of jeopardy). Also, as in the case of deficiency dividends paid by a personal holding company, if a claim for a deficiency dividend deduction is filed, collection of the remaining deficiency is to be stayed until the claim is disallowed.

The House bill contains the same provision.

Increase in distribution requirement.—Since the deficiency dividend procedure will eliminate the risk of inadvertent disqualification through failure to meet the distribution test, the committee amendment increases the portion of its income which a REIT must distribute from 90 to 95 percent for taxable years ending after December 31, 1979. The committee believes it is appropriate to delay the effective date of this increase in order to allow REITs which may have restrictions in their credit agreements relating to dividend distributions an opportunity to negotiate modifications of such agreements.

2. Distributions of REIT Taxable Income After Close of Taxable Year (secs. 1604 and 1605 of the bill and secs. 858, 860, 4981 of the Code)

Excise tax on REIT taxable income not distributed during the taxable year.—Under present law, a REIT must declare a dividend for a taxable year by the due date for filing the return for that year, but the REIT may delay actual payment of the dividend for 12 months after the close of the taxable year. For example, if a REIT is on a calendar year basis, dividends for 1973 do not have to be paid until December 31, 1974. (These dividends are hereafter called "section 858 dividends", since a deduction with respect to such dividends is allowed under section 858 of the Code.)

In general, the policy underlying the conduit treatment of REITs is that either the REIT or its shareholders will be currently taxable on the income earned by the REIT. But this policy is not fulfilled where there is a substantial use of section 858 dividends by the REIT prior to distribution, because no charge is imposed for the one-year delay in payment of the dividend even though, during this year, neither the REIT nor its shareholders are liable for tax on the REIT income. Through a repeated use of the section 858 dividends procedure, there can be a permanent loss of revenue (a permanent one-year delay).

To meet this situation, the committee amendment establishes an excise tax on late distributions of income in order to prevent this loss of revenue to the Treasury. Thus, in order to avoid the excise tax, a REIT is required to distribute at least 75 percent of its real estate investment trust taxable income as reported on its return by the close of its taxable year. If, by the end of its taxable year, the REIT has distributed less than 75 percent of its real estate investment trust taxable income (as reported on its return), it is to be subject to a nondeductible 3 percent excise tax on the difference between 75 percent of this income and the amount distributed. For example, if a REIT reports real estate investment trust taxable income of $100 for taxable year 1977 and distributes $70 of dividends by the end of this taxable year, it will be subject to a nondeductible 3 percent excise tax on $5, which is the amount by which the distribution falls short of 75 percent by the end of the taxable year.[7] The 3-percent charge is to be a one-time charge without regard to the date of the later distribution. (However, the REIT must meet the 90 percent distribution test within 12 months after the close of the taxable year in question if the trust is to qualify as a REIT.) This 3-percent excise tax is to apply to taxable years beginning after December 31, 1979.

The House bill contains the same provision.

Adoption of annual accounting period.—If a REIT's shareholders are on the calendar year for reporting income and the REIT is on a fiscal year, the REIT, by waiting until the end of its year to distribute income to its shareholders, in many circumstances can allow its shareholders a two-year delay in reporting this income. To avoid a potential two-year delay in revenue in the future, the committee amendment provides that a REIT is not to adopt in the future (or change to in the future) any annual accounting period other than the calendar year.

The House bill contains the same provision.

Dividends paid by REIT after close of taxable year.—Under present law, a REIT can, to a substantial extent, avoid an underdistribution of a prior year's income if it makes a "contingent" section 858 election. Such a "contingent" election is made when the REIT elects to have a dividend relate to a prior year only to the extent to which earnings and profits from that prior year remain undistributed. Thus, by declaring a section 858 dividend, a REIT can be "covered" for two years. This may be needed under present law where there is no deficiency dividend procedure. However, this is no longer necessary or appropriate with the deficiency dividend procedures established by the bill. Moreover, this rather loose accounting procedure facilitates the possibility that a REIT may delay distribution of its income to its

[7] Amounts counted toward the 75 percent requirement are only to be amounts that qualify for the dividends paid deduction for the current year. Therefore, any section 858 dividends or deficiency dividends (which are to relate only to a prior year) are not to be counted toward this 75 percent requirement.

shareholders, and thus delay the date on which shareholders must include such dividends in income.

With the new deficiency dividend procedure provided by the committee amendment, it is inappropriate to continue the present use of section 858 dividends as a way to avoid problems from an underdistribution of a prior year's income. Consequently, the committee's amendment amends section 858 to explicitly provide that the amount allowed as a section 858 dividend is to relate *only* to the prior taxable year and is not in any event also to relate to the taxable year in which the dividend is paid. Also, under the bill, a section 858 dividend is to be stated in a dollar amount. The amount so stated is to be the only amount of dividends paid during the year of payment which relates to the prior year, and that amount is to be a dividend only for the prior year and not for the year in which paid.

For example, in 1977 a REIT has $100 of real estate investment trust taxable income and pays a dividend of $75 in 1978, in order to meet its 1977 90 percent distribution requirement, the REIT declares and pays $15 as a section 858 dividend. For the dividend to qualify under section 858, the REIT must specify that the dividend is a section 858 dividend for 1977 and that it is in the amount of $15. This amount, then, is to relate only to 1977 and not to 1978. In 1978, the REIT also has $100 real estate investment trust taxable income. To avoid paying the excise tax on late distributions for 1978, the REIT must distribute $75 in 1978. Therefore, in 1978, the REIT would have to distribute $15 (as a section 858 dividend for 1977) plus $75 (as a dividend for 1978) for a total of $90 actually paid as dividends in 1978 in order to meet both its 90 percent distribution requirement for 1977 and to avoid the 3 percent excise tax for distributions related to income earned in 1978.

The House bill contains the same provision.

3. Property Held for Sale (sec. 1603 of the bill and secs. 856 and 857 of the Code)

Present law prohibits a REIT from holding property, other than property qualifying as foreclosure property, for sale to customers. This rule has been difficult to apply because of the absolute prohibition on holding such property and because of problems involved in determining when a REIT holds property for sale.

Because of these problems, the committee amendment eliminates the flat prohibition against a REIT holding property primarily for sale to customers in the ordinary course of its trade or business. Under the committee amendment, the sale or other disposition of property described in section 1221(1) of the Code is called as a prohibited transaction and the net income from such transactions is taxed at a rate of 100 percent. Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of propertv (other than foreclosure propertv) described in section 1221(1) with all losses and other deductions allowed by chapter 1 of the Code which are directly connected with the sale or other disposition of such proportv. Thus, for example, if a REIT sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item (and has no other deductions directly connected with prohibited transactions), the net income from prohibited transactions will be $60. Deductions directly connected with prohibited transactions are those deductions, otherwise allowed by chapter 1 of the Code, which are proximately and primarily connected with such transactions. (General overhead costs, for example, may not be allocated to income from prohibited transactions.)

Under the committee amendment, since a separate tax is applied to net gain from prohibited transactions, net gain (or net loss) from prohibited transactions is not taken into account in determining real estate investment trust taxable income.[8]

Under the House bill, a REIT would be disqualified and taxed as a regular corporation if it derived one percent or more of its gross income from the sale or other disposition of property (other than foreclosure property) held for sale to customers, unless the REIT had reasonable ground to believe and did believe that less than one percent of its gross income was from this source. Under the House bill, any income from this source, less deductions otherwise allowable which were directly connected with producing the income, would be subject to a corporate tax at a rate of 48 percent. In addition, where a REIT had holding for sale income of one percent or more but was not disqualified, such income would be subject to a second corporate tax of 48 percent, for a total tax of 96 percent. Furthermore, in certain circumstances where the REIT had failed one or more of the other source of income tests, such income could be subject under the House bill to additional taxes of up to 96 percent, for a possible 192 percent total rate of tax.

The committee believes that an additional source of income requirement is unnecessary in view of the fact that the extremely high rate of tax imposed by the House bill would serve as an adequate disincentive to assure that a REIT would not intentionally undertake the conduct of an active business. In order to simplify the provisions, the committee amendment replaces the one-percent income requirement and the various levels of corporate tax described above with a tax of 100 percent on the net income from prohibited transactions.

The 100-percent tax on net income from prohibited transactions is included to prevent a REIT from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. One transaction in particular where questions have been raised is whether a REIT holds property for sale where it enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period. Such a transaction frequently is a normal method of financing real estate and is used in lieu of a mortgage. Your committee intends that with respect to the real estate investment trust provisions, income from a sale under an option in this type of transaction is not to be considered as income from property held for sale solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was

[8] However, to prevent a REIT which has incurred a net loss on prohibited transactions from having to deplete capital in order to meet the 90 percent distribution requirement, the amount of income which must be distributed to satisfy that requirement is to be reduced by the amount of any net loss from prohibited transactions.

exercised pursuant to its terms. However, other facts and circumstances might indicate that income from the transactions described above would be income from prohibited transactions. In determining whether a particular transaction constitutes a prohibited transaction, a REIT's activities with respect to foreclosure property and its sales of such property should be disregarded. The committee intends that no inference regarding these type of transactions is to be drawn for any other purpose of the tax laws because of this treatment with respect to real estate investment trusts.

4. Failure to Meet Income Source Tests (sec. 1202 of the bill and secs. 856 and 857 of the Code)

Under present law, certain percentages of a REIT's income must be from designated sources for the REIT to receive conduit tax treatment. If the source tests (that is, the 75 percent or 90 [1] percent income source tests described above) are not met, the REIT will be disqualified and must pay taxes on its income as if it were a regular corporation. This could cause hardship for a REIT which reasonably and in good faith believed it met the income source tests and distributed substantially all of its income to its shareholders, but which does not meet one of these tests and is required to pay tax at regular corporate rates. The committee believes that, in this situation, the REIT should not be disqualified but should be required to pay a 100-percent tax on the net income attributable to the amount by which it fails to meet the income source tests.

Accordingly, the committee amendment provides that where the trust fails to meet the 75-percent or 90-percent income source test the REIT will not be disqualified if it (1) sets forth the nature and amount of its gross income qualifying for such tests in a schedule attached to its income tax return, (2) the inclusion of any incorrect information in this schedule is not due to fraud with an intent to evade tax,[9] and (3) the failure to meet the income source requirement is due to reasonable cause and not due to willful neglect.

The failure to meet an income source test will be due to reasonable cause and not due to willful neglect if the REIT exercised ordinary business care and prudence in attempting to satisfy the tests. Such care and prudence must be exercised at the time each transaction is entered into by the REIT. However, even if the REIT exercised ordinary business care and prudence in entering into a transaction, if it is later determined that the transaction is producing nonqualified income in amounts which, in the context of the REIT's over-all portfolio, could cause an income source test to be failed, the REIT must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source test will be due to willful neglect and not reasonable cause if the failure is willful. For

[1] As described below, the committee amendment increases the 90 percent source of income requirement to 95 percent for taxable years beginning after December 31, 1979. In this explanation, the requirement is referred to as the 90-percent income source test.

[9] Under this provision, a REIT may commit fraud with intent to evade tax even though it has a net loss and thus no tax liability for the year in question. This could occur where a REIT with a net loss fraudulently indicated on the schedule that it had satisfied the gross income tests so that it could avoid being disqualified for the 5-year period provided under the committee's amendment.

example, if a REIT willfully fails an income source test for a legitimate business purpose, such failure is nonetheless due to willful neglect.

Under the committee amendment, in lieu of disqualification, a 100-percent tax is imposed on the net income attributable to the greater of the amount by which the REIT failed the 90-percent test or the 75-percent test. To determine such net income, the amount by which the respective test is failed is multiplied by a fraction which reflects the average profitability of the REIT. The numerator of the fraction is real estate investment trust taxable income for the year in question (determined without regard to deductions for certain taxes and net operating losses, and by excluding certain capital gains). The denominator of the fraction is the gross income of the REIT for the year in question (determined without regard to gross income from prohibited transactions, certain gross income from foreclosure property, and certain capital gains and losses). This fraction provides a simplified way to determine the net income of the REIT from the nonqualifying income in question, without requiring an apportionment or allocation of specific deductions or expenses.

Under the House bill, if the REIT had reasonable grounds to believe and did believe that the nature and amount of its gross income satisfied the income source tests, but it was subsequently determined on audit that it did not meet the income source tests, such a REIT would not be disqualified. In these cases, the House bill would impose a tax at the corporate rate of 48 percent on the net income attributable to the amount of gross income by which the REIT failed the 90-percent test, the 75-percent test, and the 1-percent-holding-for-sale income test included in the House bill. Under the House bill, this 48 percent tax would be cumulative. Because it would be possible for the same item of income to cause the REIT to fail all three income source tests, the House bill could, as explained above, result in a tax equal to 192 percent of the net income attributable to that item. The committee believes that such a result is unwarranted. Consequently the committee amendment imposes a 100-percent tax on the greater of the amount by which the REIT fails the 90-percent income test or the 75-percent income test.[10]

Under the House bill, it would be impossible for a REIT to avoid disqualification if it learned that it failed to meet the income source tests before it filed its income tax return (even though it had reasonable cause to believe that it would meet the income source tests when it entered into the transaction which gave rise to the disqualifying income). The committee believes that such a result is unintended. Instead, the committee amendment permits the REIT to self-assess the 100-percent tax if the REIT meets the requirements described above.

It is not necessary that the schedule attached to the return referred to above indicate that the REIT has in fact satisfied income source tests. However, the 100-percent tax will not apply and the REIT will

[10] Under the committee's amendment. the 1-percent-holding-for-sale income test is eliminated, holding-for-sale income is not taken into account for purposes of the 75- or 90-percent income tests, and such income is subject to a separate, single tax of 100 percent.

be disqualified if the REIT does not meet the income source tests and the inclusion of any incorrect evidence in the schedule is due to fraud with an intent to evade tax.

It is the committee's intention that the schedule which the REIT must attach to its return to avoid disqualification contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, it is intended that the REIT, for purposes of listing its income from sources described in section 856(c) (2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. It is not the intention of the committee that the listing be on a lease-by-lease, loan-by-loan, or project-by-project basis. It is expected, however, that the REIT will maintain adequate records with which to substantiate the total amounts listed in the schedule upon audit by the Internal Revenue Service.

5. Other Changes in Limitations and Requirements (secs. 1604, 1606–7 of the bill and sec. 856 of the Code)

95 percent income source test.—Under present law, 10 percent of a REIT's gross income may be from nonqualified sources. However, the provisions of the committee amendment, as discussed below, remove a significant portion of income customarily received by REITs from the category of nonqualified income. In addition, under other provisions of the amendment, discussed above, a REIT will no longer be automatically disqualified where it fails to satisfy the income source tests, so there is less need to allow a REIT to have such income as a hedge against inadvertent disqualification. Consequently, both the committee amendment and the House bill increase the 90-percent income source test to 95 percent, so that, generally, nonqualified income may not exceed 5 percent of gross income. The committee amendment, however, delays the effective date until taxable years beginning after December 31, 1979, in order to give REITs an opportunity to negotiate modifications of existing arrangements which may be producing nonqualified income. For purposes of this test, as well as the 75-percent income source test, the committee amendment excludes gain from prohibited transactions from a REIT's total gross income as well as from gross income qualifying for the income tests.

Under the House bill, a tax is to be imposed on all nonpassive income (that is, income not described in sec. 856(c)(2)), even if the REIT satisfies all of the income source tests for the year. The committee believes that both an increase in the passive income source requirement to 95 percent and the imposition of a tax on nonpassive income is unwarranted and, consequently, the committee amendment has deleted the tax on nonpassive income.

Inclusion in qualified income of charges for customary services.—Under present law, amounts received by a REIT for services rendered to tenants, where no separate charge is made, will qualify for the 75-percent and 90-percent source tests if the services are customary and are furnished by an independent contractor. However, if a separate charge is made for customary services furnished by an independent contractor, the income tax regulations take the position that the amount of the charge must be received and retained by the independent contractor and not by the REIT. This restriction on separate charges for customarily furnished services often does not follow normal commercial practice. Consequently, the committee amendment and the House bill provide that amounts received by a REIT as charges for services customarily furnished or rendered in connection with the rental of real property will be treated as rents from real property whether or not the charges are separately stated. The committee intends that, with respect to any particular building, services provided to tenants should be regarded as customary, if, in the geographic market within which the building is located, tenants in buildings which are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. Also, in those situations where it is customary to furnish electricity to tenants, the committee intends that the submetering of electricity to tenants be regarded as a customary service.

Inclusion in qualified income of rent from incidental personal property.—Under present law, where an amount of rent is received with respect to property which consists of both real and personal property, such as a furnished apartment building, an apportionment of the rent is required. Only that part of the rent which is attributable to real property is treated as qualifying income for purposes of the income source tests.

The committee believes that where rents attributable to such personal property are an insubstantial amount of the total rents received or accrued under lease covering both real and personal property the rents should be treated as qualified income. Thus, the committee amendment adopts the rule of the House bill that rents attributable to personal property which is leased under or in connection with the lease of real property will be treated as rents from real property (and thus qualified for purposes of the income source tests) if the rent attributable to the personal property is not more than 15 percent of the total rent for the year under the lease.

The committee amendment also adopts the apportionment formula in the House bill for determining if the 15 percent test is met. Under the committee amendment, the 15 percent test is to be examined for each lease of real property. For each lease, the rent attributable to personal property is that portion of the total rent under the lease for the year determined by multiplying total rent times a fraction; the numerator of the fraction is the average of the adjusted basis of the personal property at the beginning and at the end of the taxable year; the denominator of the fraction is the average of the aggregate adjusted bases of both the real property and personal property at the beginning and at the end of the taxable year. If the rent attributable to personal property under this formula is greater than 15 percent of the total rent under the lease, then all rent attributable to personal property from the lease will be treated as nonqualifying income. In order to provide for ease of administration, the committee believes it would be appropriate for a REIT which rents units in a multiple unit project under substantially similar leases (for example an apartment buildinơ) to apply the apportionment test on the basis of the project as a whole.

Under present law, a similar problem of allocation exists with respect to interest on obligations secured by real property. While the committee believes a *de minimis* rule in this area is also appropriate, the committee amendment does not provide such a rule since the Treasury Department has indicated through the publication of proposed regulations that the issue can be resolved administratively.

Inclusion in qualified income of commitment fees.—Under present law, compensation received for an agreement to lend money where the loan is secured by real property, or received in connection with a purchase or lease of real property, is not treated as qualifying income for the income source tests. Since these fees are often part of the lending activities of a real estate investment trust, and are essentially passive in nature, both the committee amendment and the House bill include such fees as qualifying income for purposes of the 75-percent and 90-percent income source tests. The bill, however, is not intended to alter present law with respect to whether such fees constitute income. For example, a fee received for agreeing to purchase real property does not constitute income unless and until the right to require the purchase expires unexercised; if such right is exercised, the fee results in a basis adjustment.

Inclusion in qualifying assets of options to purchase real property.—Under present law, it is not clear whether options to purchase real property constitute qualified assets for purposes of the 75-percent asset test nor is it clear whether gain from the sale of options on real property is qualified income for purposes of the 75-percent income test. Since investment in options to acquire real property may be important in the operations of a real estate investment trust, such options are treated under the bill as "interests in real property" for purposes of these tests.

Use of corporate form.—Under present law, a real estate investment trust must be an unincorporated trust or unincorporated association. The committee understands that this requirement has caused operating problems for some REITs under State law. Consequently, the committee amendment adopts the rule in the House bill which provides that REITs are to be permitted to operate in corporate form. However, the committee's amendment makes clear that banks and insurance companies, which typically are engaged in other nonpassive activities, cannot qualify as REITs under these provisions.

30-percent income test.—Since the committee amendment permits REITs to have income from the sale or other disposition of property held for sale to customers, the 30-percent income test is amended by the bill to include income from the sale of such property (not including foreclosure property). In addition, the 30-percent test is amended to include income from the sale of interests in mortgages on real property held for less than four years as well as other interests in real property. The House bill contains the same provision.

Definition of "interest" for income source tests.—Following present law with respect to rents, the committee amendment and the House bill provide that "interest" does not include any amount which depends, in whole or in part, on the income or profits of any person. This is part of the overall requirement that a REIT be a passive investor and not participate in active business through a profit participation.

As in the case of contingent rents (discussed below), however, the committee amendment provides that where a REIT receives amounts which would be excluded from the term "interest" solely because the debtor of the REIT receives amounts based on the income or profits of any person, only a proportionate part of the amount received by the REIT will fail to qualify as interest. The committee believes that the approach described below with respect to the determination of the proportionate part of contingent rents which do not qualify is also a reasonable approach for determining the proportionate part of contingent interest that does not qualify. These interest provisions will apply only with respect to loans made after May 27, 1976. A loan is to be considered as made on or prior to May 27, 1976, if it was made pursuant to a binding commitment entered into on or before that date.

The committee intends that this provision is to have no effect whatsoever on the definition of the term "interest" for any other purpose.

Contingent rent.—Under present law, rent received or accrued with respect to real property which is based, in whole or in part, upon the income or profits derived by any person from the leased property does not qualify for the income source tests. On the other hand, rent received or accrued with respect to real property which is based solely upon a fixed percentage or percentages of receipts or sales does qualify for the income source tests. Where a REIT receives rent, a portion of which is based on a percentage of its tenant's gross receipts, and the gross receipts of its tenants include amounts based upon income or profits derived by any party from the property, the entire amount of the rent is non-qualifying income (and not just the portion attributable to the income or profit). For example, where the REIT leases a shopping center to a prime tenant for a rent which consists of a fixed-dollar amount plus a percentage of the prime tenant's gross receipts and the prime tenant leases one store in the shopping center to a subtenant for a rent which includes a percentage of the subtenant's profits, the entire amount of rent, fixed and contingent, received by the REIT from the prime tenant is nonqualifying income since the rent depends, in part, upon the income or profits derived by a person deriving income from the property (the subtenant). The committee believes that this rule is unduly harsh since only a portion of the rent received by the REIT is dependent upon the income or profits derived from the property. Moreover, it often is very difficult for a REIT to control the terms of the leases which the prime tenant enters into with its subtenants. Consequently, the committee has added an amendment under which only a proportionate part of the rent received by a REIT from a prime tenant is nonqualifying income to the REIT where the gross receipts of the prime tenant are based upon the net income of a person derived from the property. The proportionate part is to be determined under regulations to be prescribed by the Secretary of the Treasury.

The committee believes the following is one reasonable approach which the Secretarv of the Treasury may wish to adopt in those regulations. Where a REIT rents property to a prime tenant for a rental which is, in whole or in part, contingent on the receipts or sales of that prime tenant, and the rent which the REIT receives would be nonqualified income solelv because the prime tenant receives or accures from subtenants rent based on the income or profits derived by any person from such property, then the portion of the rent received by the REIT which is non-qualified will be the lesser of the following two amounts: (a) the contingent rent received by the REIT, or (b) an amount determined by multiplying the total rent which the REIT receives from the prime tenant by a fraction, the numerator of which is the rent received by the prime tenant which is based, in whole or in part, on the income or profits derived by any person from the property and the denominator of which is the total rent received by the prime tenant from the property. For example, assume a REIT owns land underlying a shopping center which it rents to the owner of the shopping center structure for an annual rent of $10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants which lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of $100x and, of that amount, $25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property.[11] Accordingly, the REIT will receive contingent rent of $2x (for a total rent of $12x). The portion of that rent which is disqualified is the lesser of (a) $2x (the contingent rent received by the REIT), or (b) $3x ($12x multiplied by $25x/$100x). Accordingly, $10x of the rent received by the REIT is qualified income and $2x is nonqualified income.

Net operating loss carryovers.—Under present law, a REIT is not permitted a net operating loss deduction. However, a REIT which voluntarily disqualifies itself as a REIT can carry forward a net operating loss arising in a year for which the trust qualifies as a REIT to a year for which the trust does not so qualify and claim a deduction in such year for the loss. As a result, a REIT which incurs a net operating loss may decide to voluntarily disqualify itself in order to use its loss carryover. The committee believes that a rule which forces a REIT to disqualify itself in order to be allowed a deduction which regular corporations are permitted imposes an unreasonable restriction on REIT status. Consequently, the committee has added an amendment to the House bill which permits a net operating loss carryover [12] in computing real estate investment trust taxable income for eight taxable years after the year in which the loss was incurred.

Ordinary loss offsetting capital gains.—Under present law, a REIT is taxed separately at a flat 30-percent rate on the excess of any net long-term capital gain over the sum of any net short-term capital loss and the deduction for capital gains dividends paid to its shareholders. The alternative tax on capital gains which permits a taxpayer to offset capital gains with ordinary losses, although generally available to corporations, is not available to REITs. Accordingly, a REIT cannot use an ordinary loss incurred during a taxable year to offset its capital

[11] It is irrelevant for purposes of this formula whether the reason that rent received by the prime tenant from the subtenant is based, in whole or in part, on income or profits is that (a) the lease between the prime tenant and the subtenant requires the payment of a percentage of profits, or (b) the lease between the prime tenant and the subtenant requires the payment of a percentage of gross receipts and a concession agreement between the subtenant and a concessionaire requires the payment of a percentage of the concessionaire's profits to the subtenant.

[12] Since REITs receive a deduction for income distributed to their shareholders, it would not be administratively feasible to allow a net operating loss carryback to a year for which the taxpayer was taxable as a REIT, since allowance of a net operating loss carryback might have the effect of recharacterising as a return of capital amounts distributed as dividends. Accordingly, the committee amendment does not allow a net operating loss to be carried back to a taxable year for which the taxpayer qualifies to be taxed as a REIT.

gains. As in the case of the operating loss carryovers, this rule has caused some REITs to intentionally disqualify. The committee believes that REITs should not be treated more harshly than regular corporations in this regard. Consequently, the committee has added an amendment to the House bill which, in essence, allows ordinary losses to offset the undistributed excess of net long-term capital gains over net short-term capital losses. Under the committee amendment, a REIT will compute its tax on capital gains under two methods, and determine its tax under the method which produces the lower tax liability. Under the first method, the tax on the capital gain is any additional tax arising from the inclusion of the excess of net long-term capital gain over net short-term capital loss in the trust's real estate investment trust taxable income. The second method is identical to existing law—that is, a flat 30-percent tax on such undistributed excess capital gain.

Voluntary disqualification.—Under present law, an election to be taxed as a REIT is irrevocable. If, however, a trust, either intentionally or unintentionally, fails to qualify to be taxed as a REIT for one taxable year, such trust may, nevertheless, requalify to be taxed as a REIT in the next succeeding taxable year. The committee does not believe it should be necessary for a REIT to contrive to fail one or more tests for qualification in order to terminate its REIT status. Accordingly, the committee amendment provides that a taxpayer may revoke its REIT election after the first taxable year for which the election is effective. The revocation must be made in the manner specified by the Secretary of the Treasury in regulations and must be made on or before the 90th day of the first taxable year for which the revocation is to be effective.

The committee also believes that since the net operating loss deduction and the alternative tax with respect to capital gains have been made available to REITs, taxpayers should not intentionally switch between REIT and regular corporate status. Accordingly, the committee amendment provides that if an election as a REIT has been revoked or terminated, the corporation, trust, or association (and any successor) shall not be eligible to make a new election until the fifth taxable year following the year for which the revocation or termination is effective. The five-year disqualification will not apply in the case of a termination, however, if the taxpayer (1) does not willfully fail to file an income tax return, (2) does not commit fraud in its return, and (3) establishes to the satisfaction of the Secretary of the Treasury that the failure to qualify as a REIT was due to reasonable cause and not due to willful neglect.

If a REIT has revoked or terminated its election, the prohibition on making a new election applies with respect to a successor of the REIT. It is the intent of the committee that similar rules apply for purposes of determining whether a corporation, trust, or association is a successor for purposes of section 856(g)(3) as apply for the purpose of determining under section 1372(f) whether a corporation is a successor to an electing small business corporation.

Effective date

The provisions of the committee amendment that provide for a deficiency dividend procedure are to apply to determinations that occur after the date of enactment.

The provisions that provide that a REIT is not to be disqualified in certain cases if it fails to meet the income source tests are to apply to taxable years beginning after the date of enactment. Also, such provisions are to apply to taxable years of a REIT beginning before the date of enactment if, as the result of a determination occurring after the date of enactment, such trust does not meet the income source requirements for such taxable year. In any case, however, the provisions of the amendment requiring a schedule to be attached to the income tax return are to apply only to taxable years beginning after the date of enactment.

The provisions of the amendment that provide for an alternative tax on capital gains of REITs and a deduction for net operating losses of REITs are to apply to taxable years ending after the date of enactment. (However, the provision that prohibits the carryback of a loss arising in a year in which the taxpayer qualifies to be taxed as a REIT would prevent such a loss which arose in any taxable year ending after the date of enactment from being carried back to any taxable year ending on or before the date of enactment.)

The provisions that provide that a REIT which intentionally disqualifies cannot requalify for five years is to apply to taxable years beginning after the date of enactment. However, the five-year prohibition on requalification will not apply to a REIT unless it qualifies to be taxed as a REIT for a taxable year ending after the date of enactment and subsequently intentionally fails to qualify.

The provisions that eliminate the requirement that a REIT not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business are to apply to taxable years beginning after the date of enactment. However, if after the date of enactment, it is determined on audit that a REIT violated the "holding for sale" prohibition for any taxable year ending on or before the date of enactment, the amendment will permit the REIT to elect to have the provisions apply which prevent disqualification but which instead impose a 100-percent tax on net income from prohibited transactions.

All other provisions of the committee amendment relating to REITs apply to taxable years beginning after the date of enactment.

Revenue effect

These provisions are estimated not to have any significant revenue effect.

Q. RAILROAD PROVISIONS

1. Amortizaton of track accounts (sec. 1702 of the bill and sec. 189 of the Code)

Present law

Business taxpayers in general are required under present law (sec. 263) to capitalize improvements and betterments to business and productive assets, and are generally allowed to recover these costs through depreciation deductions (sec. 167). Repairs to business and productive assets may in most cases be deducted as a current expense.

The railroad industry, however, generally has elected to use for tax purposes what is called the "retirement-replacement" method of accounting for railroad track (rail) and ties, and other items in the track accounts, instead of one of the other methods of depreciation which are used by business taxpayers generally.

For assets accounted for under the retirement-replacement method, no annual deduction for depreciation is claimed and no depreciation reserve is maintained. Under the retirement method, when new track is laid, the costs (both materials and labor) of the track and ties are capitalized. No depreciation is claimed on the original installation, but instead, when the original track or ties are replaced in later years with track or ties of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. This rule would apply, for example, when wood crossties are replaced with new wood ties. When the replacement is of an improved quality, it is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed. For example, if 80-pound rail is replaced with 100-pound rail, the cost of the 20-pound betterment portion is capitalized and the cost of the 80-pound replacement portion, less the salvage value of the recovered rail, is charged to expense, along with all labor costs incurred in the replacement.[1]

The same rules apply generally to other items in railroad track accounts, such as ballast, fasteners, other track materials, and related labor, where the retirement-replacement method of accounting is used. However, machinery which is used to build and repair rail trackage is maintained in separate accounts and depreciated using one of the other generally available methods for depreciation.[2]

The retirement-replacement method of depreciation and other depreciation methods are treated as being mutually exclusive in application to a railroad's track asset accounts. As a result, where a railroad has elected to use the retirement-replacement method under which it currently deducts replacements of existing rail, ties, ballast and

[1] A replacement with a different or improved type or kind of track or tie will, on the other hand, be treated as a retirement and substitution.

[2] Roadway equipment of railroads is allowed an "asset depreciation range" of 11 to 17 years under the class life A.D.R. system set forth in Rev. Proc. 72-10, 1972-1 Cum. Bull. 721.

other track items, it may not depreciate or amortize the costs involved in laying the original track. These original costs may only be deducted when the line is abandoned or retired.[3]

Reasons for change.

It has been indicated that much of American railway trackage is in a serious state of disrepair. In addition, it is indicated that the marginal profitability of some railroads restricts the availability of funds for the railroads to use in repairing and modernizing their trackage. Because of these factors, the committee has decided to allow an election under which the costs capitalized in railroad track accounts may be amortized over a 10-year period.

Explanation of provision.

The committee amendment provides an election for railroads to use 10-year straight-line amortization for costs which are capitalized in their track assets under the retirement-replacement method of accounting. There was no comparable provision in the House bill.

The track accounts for which this treatment is available are those presently in property accounts numbered 8 through 12 under the Interstate Commerce Commission Uniform System of Accounts for Railroad Companies. The specific items covered include ties, rail, other track materials (fasteners, etc.), ballast and labor costs associated with the installation of these materials.

For these track materials placed in service after December 31, 1976, a taxpayer which uses the retirement-replacement method may thus elect to use the 10-year amortization provision for those costs which are, under the retirement-replacement method, required to be capitalized in the track accounts.

Once the amortization election is made, it is to apply to all track costs capitalized to the track accounts in future years, unless the permission of the Secretary or his delegate is obtained to revoke the election. The Secretary or his delegate is authorized to mandate conditions and require adjustments in conjunction with granting permission to revoke the election. If railroad track assets are retired or abandoned during the amortization period for these assets, other than because of a casualty (such as a fire or flood), no loss or other deduction will be allowed because of the retirement or abandonment. Instead, the amortization deduction will continue for these assets.

Since this amortization election does not interfere in any way with the eligibility of the track account items for the investment credit, track account items for purposes of the investment credit are to be considered as having useful lives equal to the amortization period.

The Secretary or his delegate is authorized to prescribe regulations to carry out the purpose of these provisions, including, for example, a requirement that vintage accounts be maintained in order to facilitate accounting and reporting amortization under the election.

[3] This issue was recently litigated before the Tax Court. In *Chesapeake & Ohio Ry. Co. v. Commissioner*, 64 T.C. 352 (1975) the taxnayer contended that it was entitled to combine the two methods of depreciation for its track accounts and it estimated the useful life of its capitalized original track costs was 50 years. The court held that since the taxpayer had elected to use the retirement-replacement method of depreciation for its track accounts, rather than one of the generally available other methods of depreciation, the taxpayer could not in effect change its depreciation method (to a combination of methods) without the consent of the Commissioner and it could not therefore depreciate its capitalized track costs.

Effective date

The election provided by this amendment will apply to amounts paid or incurred after December 31, 1975, for track properties placed in service during taxable years beginning after this date.

Revenue effect

This provision will reduce budget receipts by $4 million in fiscal year 1977, $10 million in fiscal year 1978, and $28 million in fiscal year 1981.

2. Treatment of Certain Railroad Ties (sec. 1702 of the bill and sec. 263 of the Code)

Present Law

Business taxpayers in general are required to capitalize improvements and betterments to business and productive assets and are generally allowed to recover these costs through depreciation. The railroad industry, however, generally uses for tax purposes what is called the "retirement-replacement" method of accounting for railroad track (rail) and ties, and other items in the track accounts.

For assets accounted for under the retirement-replacement method, when new track is laid, the costs (both materials and labor) of the track and ties are capitalized. No depreciation is claimed on the original installation, but these original costs may be written off if the line is retired or abandoned. If the original installation is replaced with track or ties of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. This rule applies, for example, when wood crossties are replaced with new wood ties. When the replacement is of an improved quality, it is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed.

A replacement with a different or improved type or kind of track or tie are, on the other hand, treated as a retirement and substitution. Under this procedure, for example, when existing wood railroad ties are replaced with concrete ties, the Service has held (in Rev. Rul. 68-418, 1968-2 Cum. Bull. 115) that this replacement constitutes a retirement and substitution. As a result, the material and labor costs for the new concrete ties are to be capitalized and the costs of the old wood ties are removed from the asset account and expensed. The same treatment would apply where wood ties are replaced by ties made of steel, plastic, wood laminate, or other substitute materials which are of a different or improved type and kind.

Reasons for change

American railroads have traditionally used crossties made of hardwood timber. During some recent years, however, a shortage in hardwood ties has developed due to increased demand by competing users of hardwoods and the cyclical nature in the level of railroad track maintenance. As a result, the American railroads have begun experimenting with crossties made of substitute materials, such as concrete (and to a lesser extent, steel), both of which are significantly more expensive than hardwood ties.

The use of concrete crossties has been quite successful in some foreign countries where such ties have been used extensively for a number of years. However, the recent experimental use by American railroads suggest that under some usage conditions concrete ties, as they are presently designed, may have useful lives which are no longer than the useful lives of wood ties. However, it is likely these design problems with concrete ties will be solved or that other nonwood substitute materials (such as steel, plastic, etc.) with extended or indeterminate useful lives will be used. As a result, the committee believes that replacement use of railroad ties made of concrete or other substitute materials should be treated as betterments under the retirement-replacement method of tax accounting.

Explanation of provision

The committee amendment provides an exception to the general capitalization rules to require a modified type of betterment treatment where a domestic railroad, which uses the retirement-replacement method of accounting for depreciation of its railroad track accounts, acquires and installs replacement ties which are of a different or improved type or quality. Under this betterment treatment the taxpayer may deduct currently the costs of the improved replacement tie to the extent of the current material and installation replacement costs of the prior type of tie. When a wood tie is replaced with a concrete tie, for example, any excess in the costs of the concrete replacement tie is to be capitalized. In addition, the current deductions for the replacement tie is, as under current law, reduced by the salvage value of the wood tie which is recovered in the replacement process. This amendment is a substitute for the House provision under which the entire costs of a different or improved type of railroad tie were allowed to be deducted currently.

Effective date

This amendment will apply to amounts paid or incurred after December 31, 1975, in taxable years beginning after this date.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of less than $5 million annually.

3. Amortization of Railroad Grading and Tunnel Bores (sec. 1702 of the bill and sec. 185 of the Code)

Present law

Domestic railroad common carriers may amortize railroad grading and tunnel bores placed in service after 1968 on a straight-line basis over a 50 year period. This amortization deduction is to be in lieu of any depreciation or any other amortization deduction for these grading and tunnel bores for any year for which the election applies. If the taxpayer elects to use this provision, it applies to all railroad grading and tunnel bores qualified for this amortization, unless the Secretary permits the taxpayer to revoke the election. The 50-year amortization period begins the year following the year the property is placed in service.

Railroad grading and tunnel bores, for which the 50-year amortization deduction is available, are all improvements that result from excavations (including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace or restore a roadbed or right-of-way for railroad track. Expenditures incurred from such improvements to an existing roadbed or railroad right-of-way are treated as costs incurred for property placed in sevice in the year in which the costs are incurred.

If a railroad grading or tunnel bore is retired or abandoned during a year for which this provision is in effect with respect to it, no deduction is to be allowed because of the retirement or abandonment. Instead, the amortization deduction under this provision is to continue to apply in the case of this property. An exception to this rule, however, is provided where the retirement or abandonment is attributable primarily to fire, storm, or other casualty. In such cases, the casualty loss deduction will be available in lieu of any further amortization ddeuction.

Reasons for change

Until the Tax Reform Act of 1969, no depreciation or amortization deduction could be taken by railroads for construction of railroad grading and tunnel bores. Although these expenses could be capitalized, railroads could not depreciate them over any period because the length of their useful life is uncertain and, it seemed, indefinitely long.

In enacting this provision in 1969, Congress decided that uncertainty about the expected useful life of railroad grading and tunnel bores could be resolved by selecting an arbitrary, long period as the useful life. Thus, railroads slowly could recoup the costs of these investments in relatively small annual charges.

Since approving the allowance for 50-year amortization was a significant departure from existing tax policy. Congress chose in 1969 to provide amortization for railroad grading and tunnel bores only on a prospective basis. As a result, the cost of this property placed in service before 1969 has not been depreciable for tax purposes, unless a useful life was established for tax purposes.

In the intervening period, the committee has studied whether amortization of past investments in railroad property should be permitted on this basis. The basic issue of allowing amortization of this otherwise nondepreciable property was resolved in the 1969 Act, and fair valuation of property placed in service in the past has been reached for the vast majority of grading and tunnel bores by the Interstate Commerce Commission and counterpart State regulatory bodies. As a result, your committee believes it is now appropriate to extend the 50-year amortization to railroad grading and tunnel bores placed in service before 1969.

In some instances in recent years, taxpayers have entered into litigation with the Federal Government to establish a depreciable base for railroad grading and tunnel bores under pre-1969 law. The committee does not intend that the election for 50-year amortization in section 185 will prejudice the rights of a taxpayer to seek an administrative or judicial determination of a depreciable base.

Explanation of provision

The committee amendment provides that taxpayers may elect 50-year amortization for railroad grading and tunnel bores placed in service before January 1, 1969 (pre-1969 railroad grading and tunnel bores). The provision is the same as that included in the House bill. The amortizable basis of pre-1969 grading and tunnel bores that were acquired or constructed after February 28, 1913, is to be the adjusted basis of the property for determining capital gain in the hands of the taxpayer. For grading and tunnel bores in existence on February 28, 1913, the amortizable basis is to be that ascertained by the Interstate Commerce Commission as the property's cost of reproduction new, i.e., the then current cost of reproduction. If the valuation was made by a State regulatory agency that is the counterpart of the ICC, the adjusted basis of the property is to be the value of the property originally determined by the State agency. Where it has not been possible to establish a valuation for amortization under either of the procedures referred to, but the taxpayer or the Secretary can establish the adjusted basis for determining gain of the property in the hands of the taxpayer, the adjusted basis of the property in the hands of the taxpayer for determining gain is to be used.

The rules for determining the basis of railroad grading and tunnel bores are tied directly to existing procedures for that purpose. Since March 1, 1913, the Interstate Commerce Commission has been responsible for establishing the valuation of all railroad property, employing alternative valuation methods which include among them the cost of reproduction new. State governments generally have instructed their regulatory commissions to institute parallel evaluations for railroad property that would not be included within the ICC jurisdiction.

Grading and tunnel bores acquired or constructed since 1913 have readily established basis values because actual costs will have been established by the ICC or a State commission. Similarly, where disputes about valuations have not yet been resolved, the committee decided that for the purpose of this provision it would utilize a valuation that already had been determined for another Federal tax purpose, namely, the basis for determination of capital gain or loss.

Effective date

This provision is to be effective for any taxable year that begins after December 31, 1974.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $21 million in fiscal year 1977 and $18 million a year thereafter.

4. Limitation on use of investment tax credit for railroad property (sec. 1701 of the bill and sec. 46 of the Code)

Present law

The amount of the credit that a taxpayer may take in any one year generally cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. However, in the case of public utility property, the 50-percent limit has been increased to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980.

Investment credits which because of the limitation cannot be used in the current year may be carried back 3 taxable years and then carried forward 7 taxable years and used in those years to the extent permissible within the limitations applicable in those years. Unused investment credits that are carried back or carried forward to another year may be used to offset tax liability in the year in question only after credits earned in that year have been used to offset tax liability in that year.

Reason for change

Railroads have been investing heavily in equipment and facilities during the past several years in order to expand the ability of the railroad system to handle an increasing volume of traffic and to modernize the system through replacement of obsolete and obsolescent equipment and facilities. Additional expansion of the railroad system also is needed to connect new and reopened coal mines with principal railroad routes as reliance on coal as a fuel and energy source increases relative to other sources. Railroad equipment and facilities tend to be capital intensive and long-lived.

In contrast with the growth in investment requirements, earnings of railroad companies have been relatively small. Because the limitations on the amount of investment credit that may be claimed in a given year are expressed in terms of a percentage of tax liability, the low earnings has left railroad companies with substantial amounts of unused investment credits which soon will expire. The railroads also face the prospect that future investment credits earned on the installation of new equipment and facilities will accrue faster than profits and tax liabilities grow. As a result, railroads may continue to lose unused investment credits at the end of the carryforward period even though the investment was undertaken in anticipation of reducing future tax liabilities to the full extent of the credits they earned.

The committee's decision to relieve all taxpayers of the problem of unused credits by making them refundable in the future does not provide any taxpayer relief currently or in the future before 1984. The decision to allow two additional years (1977 and 1978) of carryforward for credits that expire at the end of 1976 would not be helpful to the railroads because present investment plans through 1978 will generate enough credits for most railroads to virtually use up the full amount of the limitation against current tax liability.

In view of these considerations the committee believed that additional steps are necessary to assist the railroads in applying unused investment credits against their tax liability.

Explanation of the provisions

Restructuring sequence of credits.—Under the committee amendment in applying investment credits against tax liability in any current tax year, railroads are to be allowed to apply unused credits earned in the earliest year first, then the second earliest year and so forth, until all unused credits earned in prior years have been used up, before credits earned in the current year are to be applied against current tax liability. If the sum of prior year credits exceeds the amount of current tax liability that may be offset, unused credits from the most recent prior years and from the current year are to be carried forward to the next year. There was no comparable provision in the House bill. For illustration, assume that a taxpayer has unused credits from year 1 which have been carried forward 6 years to year 7. Assume there are no unused credits arising in the intervening years. In year 7, the committee amendment provides that the carryforward from year 1 (to the extent not used in prior years) is to be applied against that year's tax liability before any credits earned currently. Under present law, the credit carried over from year 1 would, of course, be applied against year 8 tax liability only to the extent there was income in the current year (within the limitation) that had not been offset by credits earned currently.

Temporary increase in limitation of liability.—The committee also provided a temporary increase in the limitation on the amount of investment tax credit which may be used in a year. This provision permits railroads to apply investment tax credits against 100 percent of their tax liability in 1977 and 1978. This limitation decreases by 10 percentage points in each of the subsequent five years until the limitation reverts to 50 percent in 1983. This provision is analogous to the increase in the limitation on use of the investment credit that was enacted for public utility property in the Tax Reduction Act of 1975.

There are no comparable provisions in the House bill.

Effective date

Restructuring the carryback and carryforward provisions of the investment credit to permit prior year unused credits to be offset against current tax liability before current year credits is to be effective with respect to computations made in years ending after December 31, 1975.

The temporary increase in the limitation to 100 percent is to be effective with respect to computations made in years ending after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $29 million in fiscal year 1977, $66 million in fiscal year 1978, and $41 million in fiscal year 1981.

5. Investment credit for certain railroad property (sec. 703 of the bill and sec. 46 of the Code)

Present law

From 1969 through December 31, 1975, railroad rolling stock had been eligible for five-year, straight-line amortization as an alternative to the usual depreciation choices. When it was enacted, it was provided as an incentive for the railroads to continue modernizing and expanding their stock of freight cars and locomotives. The investment tax credit was repealed effective April 18, 1969, in the same law in which the amortization provision was enacted. This provision initially was enacted through 1974 but was subsequently extended through 1975.

Railroad equipment used as an integral part of a communication, signal or traffic control system, a rolling stock classification yard or a facility for loading or unloading trailers or containers from railroad flat cars are eligible for depreciation and the investment credit under present law provisions. Generally, these types of equipment have 14-year guideline lives for depreciation purposes and are eligible to select a depreciation period between 11 and 17 years under the ADR system. With useful lives for depreciation purposes in excess of six years, these types of equipment are eligible for the full investment credit.

Reasons for change

Current and prospective rates of growth in railroad traffic are associated with the combination of normal growth attributable to growth in the economy and also to additional traffic as a response to efforts to economize on consumption of oil and natural gas fuels. In addition, railroads are increasing their freight-movement capacities by expanding their stocks of railroad cars and by building freight cars able to carry heavier loads. Furthermore, the facilities for controlling the flow of traffic, assembling and disassembling trains and for loading or unloading truck trailers have not been appropriately developed during long years of financial inability to maintain and modernize the existing railroad system. An increase in investments in freight carrying capacity and in the road and track structures could greatly improve the speed and efficiency of railroad transportation. The needed expansion in railroad transportation services will require very substantial investments throughout the industry in the years ahead.

The House, in its version of the energy tax bill, provided temporary tax incentives for the types of railroad investment referred to above by providing five-year amortization for railroad rolling stock and for equipment used in communications and control systems, classifications yards and for loading and unloading truck trailers from freight cars. These provisions were to apply during the period from January 1, 1975, through December 31, 1979. The House bill also made the investment credit available to railroad property for which five-year amortization has been elected. The investment credit available in these cases, under the House provision, assumed the same useful life for investment credit purposes as for purposes of the five-year amortization provision. As a result, two-thirds of the credit would have been available in conjunction with the amortization provision for equipment and rolling stock that alternatively could have a full investment credit and be depreciated over 11 years under ADR.

The committee amendment takes into consideration provisions included in the House energy tax bill. The committee concluded, however, that it is more efficient to provide a temporary increase in the investment credit to 12 percent, in lieu of the generally available 10 percent, and allow the railroads to maintain a uniform, consistent accounting system for all its depreciable equipment. Use of the five-year amortization requires establishment of a separate set of accounting records for amortization property. The committee amendment provides a marginally better tax reduction without this compliance problem.

Explanation of provision

This provision makes available a 12-percent investment credit for railroad rolling stock and depreciable, tangible property that is an integral part of (1) a communications, signed or traffic control system, (2) a rolling stock classification yard, or (3) a facility for loading and unloading trailers and containers on and from railroad cars.

For the purposes of this provision, equipment that is an integral part of communications, signal and traffic control systems may include signals and interlockers and components of electronics communications systems which may be radio, radar and microwave systems. In rolling stock classification yards, eligible equipment means the equipment for the routing of railroad rolling stock which includes lighting, computers, signals and other electronic devices necessary for operation and control of a classification yard, and facilities for the movement of cars and locomotives. Facilities for loading or unloading trailers and containers means structures, fixtures, machinery and appurtenances that comprise terminals for this loading and unloading.

Rolling stock includes locomotives and all types of freight cars used by a domestic railroad on a full-time basis or on a part-time basis when shared with a Canadian or Mexican railroad common carrier on a per diem basis. The term rolling stock also includes railroad cars used predominantly within the United States to haul coal if used by the taxpayer in his trade or business. This amendment will permit a taxpayer to purchase, for example, gondolas or hoppers to carry coal from a coal mine to the site of his business. The taxpayer could be a public utility that burns coal as the fuel used in generating electricity or another business which burns coal in relation to a manufacturing process. Taxpayers who are in the business of purchasing coal for resale to others, however, are not eligible for the 12 percent credit.

The railroad equipment covered by this provision (except for coal cars) is equipment used by a common carrier engaged in railroad transportation and subject to the jurisdiction of the Interstate Commerce Commission. The equipment must be used full-time by a domestic railroad common carrier or part-time when its only other use is by a Canadian or Mexican railroad common carrier on a per diem basis. Qualified railroad equipment also may be used and owned by a carline company, and by a switching or terminal company at least 95 percent of whose stock is owned by one or more domestic railroad common carriers.

Effective date

This provision applies to eligible equipment placed in service after December 31, 1976, and before January 1, 1982.

Revenue effect

This provision will reduce budget receipts by $2 million in fiscal year 1977, $5 million in fiscal year 1978, and $5 million in fiscal year 1981.

R. TAX CREDIT FOR HOME GARDEN TOOLS

The House bill contained a 7-percent tax credit for the initial $100 of home garden tool expenditures.

The committee deleted this provision because it would add complexity to the tax form and because the Internal Revenue Service would not be able to verify whether people actually made the expenditures on which the credit would be based.

S. "DEADWOOD" PROVISIONS: REPEAL AND REVISION OF OBSOLETE, RARELY USED, ETC., PROVISIONS

The provisions described in this title reflect a series of changes which have been developed over a number of years as an attempt to simplify the tax laws by removing from the Internal Revenue Code those provisions which are no longer used in computing current taxes or are little used and of minor importance. These changes have been popularly referred to as the "deadwood" provisions.

This provision was previously approved by the Finance Committee on December 18, 1975, as a committee amendment to be offered on the floor of the Senate. In a slightly different form, these provisions also appear as title XIX of H.R. 10612.

The deadwood title would repeal almost 150 sections of the Internal Revenue Code; it would amend about 850 other sections. These provisions also contain approximately 2,370 amendments to the Code (including the repealer provisions and changes where one section of the Code would be amended several times).

This title would delete provisions in present law which deal only with past years, situations which were initially narrowly defined and are unlikely to recur, as well as provisions which have largely, if not entirely, outlived their usefulness. In addition, several amendments would eliminate sex discrimination in the Code.

These provisions would also make simplifying changes, such as substituting the term "ordinary income" for "gain from sale or exchange of property which is not a capital asset or property described in section 1231." The term "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year" is replaced by "net capital gain." In another simplifying change, all references to "the Secretary or his delegate" are amended to refer only to "the Secretary" (which term will include his delegates), except where an act or regulation is required to be done or issued by the Secretary of the Treasury personally, in which case the Code will refer specifically to "the Secretary of the Treasury."

While these provisions are an attempt to simplify the code by deleting "deadwood," they do not attempt to achieve simplification through substantive changes in present law.

Following is a section-by-section explanation of the deadwood provisions of title XIX.

PART I—AMENDMENTS OF INTERNAL REVENUE CODE GENERALLY

SEC. 1900 (AMENDMENT OF 1954 CODE)

This section of the committee amendment eliminates the need for repeated references to the Internal Revenue Code of 1954 in this bill by providing that, when the amendment refers to an amendment or repeal of a section or other provision, that is to be considered an amendment or repeal of a section or other provision of the Internal Revenue Code.

SEC. 1901. AMENDMENTS TO SUBTITLE A; INCOME TAXES

Chapter 1. Normal Taxes and Surtaxes

Subchapter A. Determination of tax liability

Sec. 1901(a)(1) (amends sec. 2 of the Code)—definitions and special rules

This amendment makes it easier to read a provision relating to the tax status of certain married individuals living apart.

Sec. 1901(a)(2) (amends sec. 11 of the Code)—surtax on corporations

This amendment strikes out a reference to the surtax applicable to corporations for taxable years beginning before 1965.

Sec. 1901(a)(3) (repeals sec. 35 of the Code)—partially tax-exempt interest received by individuals

This amendment repeals section 35 of the Code (relating to partially tax-exempt interest received by individuals), because there are no longer any outstanding Federal obligations producing interest which is partially tax-exempt under that section.

Section 242 of the Code, relating to such interest received by corporations, is repealed by section 1901(a)(33) of the amendment. Appropriate conforming amendments striking out references to Code sections 35 and 242 and to partially tax-exempt interest in other Code sections are also made by the amendment.

Sec. 1901(a)(4) (amends sec. 37 of the Code)—retirement income credit

This amendment strikes out a provision allowing a credit for retirement income at a special percentage rate in the case of a taxable year beginning in 1964. If there is an individual whose 1964 tax year is open, the higher percentage for that year would be preserved to that person because the effective date of the deadwood amendments would not reach back retroactively to foreclose that person's right to that higher 1964 rate.

Sec. 1901(a)(5) (amends sec. 39 of the Code)—credit for taxes paid on gasoline, special fuels, and lubricating oil

These amendments strike out a transitional rule for the years 1965, 1966, and 1967 and conform the last sentence in Code section 39 to an amendment made by section 1906(a)(32)(B) of the amendment.

Sec. 1901(a)(6) (amends sec. 46 of the Code)—investment credit

Subparagraph (A) corrects a clerical error in the Employee Retirement Income Security Act of 1974 ("ERISA"). Subparagraphs (B) and (C) strike out special provisions which applied to an unused investment credit carryback to a taxable year beginning before 1962. Subparagraph (D) changes a citation to conform with current practice.

Sec. 1901(a)(7) (amends sec. 48 of the Code)—definitions and special rules

These amendments change citations to conform with current practice.

Sec. 1901(a)(8) (amends sec. 50A of the Code)—work incentive credit

This amendment corrects a clerical error in ERISA.

Sec. 1901(a)(9) (repeals sec. 51 of the Code)—tax surcharge

This amendment repeals tax surcharge provisions applicable to 1968, 1969, and 1970.

Sec. 1901(a)(10) (amends sec. 56 of the Code)—carryovers of minimum tax

This provision corrects a clerical error.

Sec. 1901(a)(11) (amends sec. 57 of the Code)—tax preference of excess investment interest for tax years before January 1, 1972

These amendments eliminate the treatment of excess investment interest as a tax preference item for tax years beginning before January 1, 1972. These provisions are now obsolete. The provisions of section 163(d) of the Code replaced these provisions for subsequent tax years. Because the effective date of the amendments made by this title of the bill do not operate retroactively, the provisions of section 57 as in effect for tax years beginning before January 1, 1972, would continue to control in those taxable years.

Subchapter B. Computation of taxable income

Sec. 1901(a)(12) (amends sec. 62 of the Code)—penalties for early withdrawal of funds from certain savings accounts

Section 62 contains two paragraphs numbered (11). In 1974, Public Law 93-483 added to section 62 a new paragraph (11) (allowing a deduction from gross income for interest "penalties" incurred upon early withdrawals from time savings accounts or deposits). A few months earlier, ERISA had also added a new paragraph (11) (pertaining to lump sum distributions from certain pension plans). Subparagraph (A) of the present bill redesignates the paragraph added by Public Law 93-483 as paragraph (12).

Subparagraph (B) corrects a clerical error in the paragraph redesignated as paragraph (12).

Sec. 1901(a)(13) (adds secs 64 and 65 to the Code)—definitions of ordinary income and ordinary loss

This paragraph adds two new sections to the Code. Both new sections are intended to replace the cumbersome and lengthy terminology of present law which describes certain gains from sales or exchanges of property which do not qualify as capital gains. Many provisions of present law describe these gains (or losses) as : "gain (or loss) from the sale or exchange of property which is not a capital asset or property described in section 1231(b)."

For such language, the amendment substitutes shorter terms: "ordinary income" and "ordinary loss".

"Ordinary income" is defined as including "any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) and any other gain which, under other provisions of this subtitle, is to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)."

"Ordinary loss" is defined as including "any loss from the sale or exchange of property which is not a capital asset and any other loss which, under other provisions of this subtitle, is to be treated as loss from the sale or exchange of property which is not a capital asset."

Gain and loss described in present law as "deemed" or "considered" to be gain (or loss) from the sale or exchange of property which is not a capital asset, etc. or gain and loss described with similar terms, is thus to be treated as ordinary income or ordinary loss under the new terminology.

Sec. 1901(a)(14) (amends sec. 72 of the Code)—annuities; certain proceeds of endowment and life insurance contracts

Subparagraph (A) strikes out an internal effective date (January 1, 1954) and a reference to prior laws no longer needed. Subparagraph (B) corrects a clerical error in ERISA.

Sec. 1901(a)(15) (amends sec. 72 of the Code)—mortgages made or obligations issued by joint-stock land banks

This amendment repeals an obsolete provision relating to the taxation of income (except interest) from joint-stock land bank mortgages or obligations. Joint-stock land banks have not been permitted to make new loans after May 12, 1933, and it is understood that there are no joint-stock land bank mortgages or obligations currently outstanding.

Sec. 1901(a)(16) (amends sec. 83 of the Code)—property transferred in connection with performance of services

This amendment strikes out an internal effective date ("30 days after the date of the enactment of the Tax Reform Act of 1969") relating to a date by which a certain election could be made.

Sec. 1901(a)(17) (amends sec. 101 of the Code)—certain death benefits

This amendment strikes out an internal effective date.

Sec. 1901(a)(18) (amends sec. 103 of the Code)—interest on certain governmental obligations

These amendments strike out provisions relating to the tax-exempt status of interest on United States obligations, since there are no outstanding obligations of the United States or of any United States instrumentality which pay interest that is exempt from tax under this section. Also, the list of cross references in section 103(e) of the Code is updated.

Sec. 1901(a)(19) (amends sec. 104 of the Code)—compensation for injuries or sickness

This amendment makes conforming changes in citations to other titles of the United States Code.

Sec. 1901(a)(20) (amends sec. 115 of the Code)—income of States, municipalities, etc.

This amendment repeals subsections (b) and (c) relating to certain contracts entered into before September 8, 1916, and May 29, 1928 (relating to certain public utilities and certain bridge acquisitions, respectively), since it appears that no such contracts are still in effect.

Sec. 1901(a)(21) (amends sec. 116 of the Code)—partial exclusion of dividends received by individuals

This amendment strikes out an internal effective date.

Sec. 1901(a)(22) (amendm sec. 124 of the Code)—cross references to other Acts

This amendment updates a list of cross references to other Acts.

Sec. 1901(a)(23) (amends sec. 143 of the Code)—determination of marital status

This amendment makes section 143 (relating to determination of marital status) applicable for purposes of part V (deductions for personal exemptions) of subchapter B, as well as for purposes of part IV (standard deduction) of that subchapter. As a result of this amendment, section 153 becomes redundant and is repealed by section 1901(b)(7)(A)(i) of this title.

Sec. 1901(a)(24) (amends sec. 151 of the Code)—allowance of deductions for personal exemptions

This amendment replaces the definition of "educational institution" with a cross reference to a similar definition in section 170(b)(1)(A)(ii). This consolidates in one section the definition of an "educational organization." The amendment makes conforming amendments to 12 other Code sections to reflect this change. (Note that an educational organization described in clause (ii) of section 170(b)(1)(A) may be a private, for-profit school. However, even though such a school could satisfy the requirements of the dependency provisions (relating to full-time students), it could not be an eligible donee of deductible charitable contributions, because it could not satisfy the requirements of any of the paragraphs of subsection (c) of section 170).

Sec. 1901(a)(25) (amends sec. 152 of the Code)—definition of dependent

Subparagraph (A) deletes the "sick cousin rule," which includes as dependents certain distant relatives receiving institutional care who previously had resided with the taxpayer. This provision was added to the Code to cover an unusual situation unlikely to recur.

Subparagraph (B) eliminates another provision allowing dependency deductions under two rarely used rules. Under one of these rules, a child residing in the Philippine Islands qualifies as a dependent if he was born to, or adopted by, the taxpayer in the Philippines before January 1, 1956, if the taxpayer was then a member of the U.S. Armed Forces. Under the other rule, a resident of the Canal Zone or Panama may be claimed as a dependent although he is not a citizen or national of the United States.

Sec. 1901(a) (26) (amends sec. 164 of the Code)—deduction for taxes

These amendments strike out an effective date provision (sales after December 31, 1953) and an obsolete transitional rule, both of which relate to the apportionment of taxes on real property between seller and purchaser.

Sec. 1901(a) (27) (amends sec. 165 of the Code)—losses

These amendments strike out the provision that treats Cuban expropriation losses of individuals on personal-use assets as casualty losses, since this provision applies only to losses sustained before January 1, 1964.

Sec. 1901(a) (27) (amends sec. 167 of the Code)—depreciation

Subparagraph (A) substitutes "August 16, 1954," for "the date of enactment of this title" as the effective date of a provision.

Subparagraph (B) deletes transitional rules for a change in the method of depreciation with respect to section 1245 property (applicable to the first taxable year beginning after December 21, 1962).

Subparagraph (C) substitutes "October 16, 1962" for "the date of enactment of the Revenue Act of 1962" as the effective date of a provision.

Subparagraph (D) substitutes the exact date ("before June 29, 1970,") for "within 180 days after the date of enactment of this subparagraph," as the date by which an election must have been made under a provision.

Sec. 1901(a) (29) (amends sec. 170 of the Code)—charitable, etc., contributions and gifts

Subparagraph (A) strikes out the unlimited deduction for charitable contributions, which, by its own terms, expires for taxable years beginning after December 31, 1974.

Subparagraph (B) deletes a special percentage rate by which excess charitable contributions from a contribution year beginning before January 1, 1970, could be carried over to subsequent taxable years.

Subparagraphs (C) and (D) eliminate an unnecessary citation and bring up to date statutory citations in the cross references at the end of section 170.

Sec. 1901(a) (30) (amends sec. 172 of the Code)—net operating loss deduction

Subparagraph (A) deletes the special five year loss carryback permitted to American Motors Corporation in 1967 (sec. 172(b) (1) (E)), which has now expired by its own terms.

Subparagraph (B) strikes out an obsolete effective date provision (taxable years ending after December 31, 1953), relating to the definition of net operating loss.

Subparagraphs (C) and (E) delete obsolete transitional rules for 1953 and 1954, for 1957 and 1958, and for 1955 and 1956. Subparagraph (D) deletes a reference to the date of January 1, 1954, which is no longer necessary.

Sec. 1901(a)(31) (amends secs. 174 and 175 of the Code)—research and experimental expenditures and soil and water conservation expenditures

These amendments delete "the date on which this title is enacted" and substitute the exact date, August 16, 1954.

Sec. 1901(a)(32) (amends sec. 219 of the Code)—disqualification of governmental plan participants from distributing to individual retirement accounts

This provision corrects a clerical error in ERISA.

Sec. 1901(a)(33) (repeals sec. 242 of the Code)—partially tax-exempt interest received by corporations

Section 242 of the Code is repealed because there are no longer any outstanding Federal obligations that pay interest that is partially exempt from income tax under that section. (See the corresponding repeal of sec. 35 of the Code, by sec. 1901(a)(3) of this title.)

Sec. 1901 (a)(34) (amends sec. 243 of the Code)—dividends received by corporations

Subparagraph (A) adds a citation to the Investment Act of 1958.

Subparagraph (B) strikes out a parenthetical clause which applies only in certain cases in which the taxable year of a member corporation in an affiliated group began in 1963 and ended in 1964.

Sec. 1901 (a)(35) (amends sec. 247 of the Code)—dividends paid on certain preferred stock of public utilities

This provision revises section 247(b)(2) of the Code (defining preferred stock) to make it easier to read. The substance of the definition is unchanged.

Sec. 1901(a)(36) (amends sec. 248 of the Code)—organizational expenditures

This amendment substitutes "August 16, 1954" for "the date of enactment of this title" as the effective date of this provision.

Sec. 1901(a)(37) (amends sec. 265 of the Code)—expenses and interest relating to tax-exempt income

This amendment strikes out an obsolete reference to tax-exempt interest from obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer. No such obligations paying tax-exempt interest are outstanding.

Sec. 1901(a)(38) (amends sec. 269 of the Code)—acquisitions made to evade or avoid income tax

This amendment repeals the presumption of a tax avoidance purpose in certain cases where the consideration paid for stock or assets of a corporation is disproportionate to the total of the adjusted basis of the assets of the acquired corporation plus the amount of tax benefits obtained through the acquisition (sec. 269(c)).

This presumption seems to be contrary to the purpose of the provision; i.e., usually tax avoidance motives would be more apt to be present where the value of "tax benefits" was paid for, than they would be where the "tax benefits" were not given weight. Moreover, under general tax litigation principles, the Commissioner's determination of a tax avoidance motive is presumptively correct and the burden of proof is already on the taxpayer.

Sec. 1901(a)(39) (amends sec. 275 of the Code)—nondeductible taxes

This amendment deletes the obsolete reference to corresponding provisions of prior, i.e., pre-1954 Code, laws in the provision denying a deduction for income tax withheld from wages.

Sec. 1901(a)(40) (amends sec. 278 of the Code)—capital expenditures incurred in planting and developing citrus and almond groves

Under present law, expenses of planting, cultivating, maintaining, or developing a citrus or almond grove, and which are incurred during the first four years of the planting of the grove, must be capitalized (rather than deducted as paid on the cash method of accounting). Exceptions to this rule are provided (1) for a grove replanted after a casualty loss, and (2) for a grove planted or replanted before December 30, 1969, in the case of a citrus grove, or before December 30, 1970, in the case of an almond grove.

The amendment removes the second of these exceptions as no longer needed (since the four-year period has now expired in those cases).

Sec. 1901(a)(41) (amends sec. 281 of the Code)—terminal railroad corporations

Subparagraph (A) inserts a citation to the Interstate Commerce Act.

Subparagraph (B) strikes a transitional provision applicable to taxable years ending before October 23, 1962.

Subchapter C. Corporate distributions and adjustments

Sec. 1901(a)(42) (amends sec. 301 of the Code)—corporate distributions

This provision repeals section 301(e) of the Code, which relates to distributions out of certain earnings and profits by corporations which were classified as personal service corporations under the Revenue Acts of 1918 or 1921. It is not believed that there are any such corporations that have not already distributed the earnings and profits to which this section applies.

Sec. 1901(a)(43) (amends sec. 311 of the Code)—taxability of corporation on distribution

Subparagraph (A) corrects a clerical error in subsection (d)(1) which occurred in 1969 when the two words "a gain" were erroneously printed as "again".

Subparagraph (B) strikes out one of the exceptions to the general rule of subsection (d)(1) requiring recognition of gain at the corporate level on a redemption distribution of appreciated property. The deleted exception relates to certain distributions required to be made before December 1, 1974.

Subparagraph (C) strikes out two unnecessary statutes-at-large citations.

Sec. 1901(a)(44) (amends sec. 312 of the Code)—effect of distributions on earnings and profits

Subparagraph (A) makes two clerical corrections in replacing references to "this Code" with references to "this title."

Subparagraph (B) deletes a subsection providing rules for computing earnings and profits with respect to distributions by personal service corporations under the 1939 code. Since earnings and profits adjustments for a taxable year are based on the law applicable to that year, this amendment does not affect the current taxable year and future years.

Subparagraphs (C) and (D) strike out effective dates that do not apply to current taxable years.

Sec. 1901(a)(45) (amends sec. 333 of the Code)—election as to recognition of gain in certain liquidations

This amendment strikes out an obsolete effective date provision (June 22, 1954) relating to adoption of a plan of liquidation of a corporation.

Sec. 1901(a)(46) (amends sec. 334 of the Code)—basis of property received in liquidations

This amendment deletes an obsolete effective date provision (June 22, 1954) relating to adoption of a plan of corporate liquidation.

Sec. 1901(a)(47) (amends sec. 337 of the Code)—gain or loss on sales or exchanges in connection with certain liquidations

These amendments delete obsolete effective date provisions (June 22, 1954, and January 1, 1958) relating to adoption of a plan of corporate liquidation.

Sec. 1901(a)(48) (repeals sec. 342 of the Code)—liquidation of certain foreign personal holding companies

This amendment repeals the provision taxing, as short-term capital gain, gain on the liquidation of certain corporations that were foreign personal holding companies in 1937. The corporations affected by this provision were given a chance to liquidate at long-term capital gain rates for a period after this provision was enacted, and again in 1954 through 1956. Moreover, the rule does not apply to sales of stock, and long-term capital gain rates could be obtained by selling the stock rather than liquidating the corporation. It seems likely that the provision will rarely, if ever, be applied, and therefore is deleted as unimportant and rarely used.

Sec. 1901(a)(49) (amends sec. 351 of the Code)—transfer to controlled corporations

These amendments strike out an obsolete effective date (June 30, 1967) and a transitional rule. They also make explicit the rule of present law that a transfer to an investment company (a so-called "swap fund") is not accorded tax-free exchange treatment under section 351.

Sec. 1901(a)(50) (repeals sec. 363 of the Code)—effect on earnings and profits

This provision repeals an unnecessary cross reference provision relating to the effect on earnings and profits of corporate organizations and reorganizations.

Sec. 1901(a)(51) (amends sec. 371 of the Code)—reorganization in certain receivership and bankruptcy proceedings

These amendments strike out unnecessary citation references and insert a citation to the U.S. Code.

Sec. 1901(a)(52) (amends sec. 372 of the Code)—basis in connection with certain receivership and bankruptcy proceedings

This amendment strikes out an unnecessary citation reference to the Statutes at Large.

Sec. 1901(a)(53) (repeals sec. 373 of the Code)—loss not recognized in certain railroad reorganizations

This provision repeals the provisions for nonrecognition of loss on transfers made before August 1, 1955, in certain railroad reorganizations, pursuant to a court order. The related basis provisions are moved to section 374(b) of the Code by section 1901(b)(12)(B) of the title.

Sec. 1901(a)(54) (amends sec. 374 of the Code)—gain or loss not recognized in certain railroad reorganizations

This amendment revises a citation to the Bankruptcy Act to conform to current practice.

Sec. 1901(a)(55) (amends sec. 381 of the Code)—carryovers in certain corporate acquisitions

This amendment deletes an obsolete provision dealing with the deduction by the acquiring corporation of contributions to a pension plan made by its wholly-owned subsidiary whose assets were acquired in a liquidation subject to the 1939 Code.

Sec. 1901(a)(56) (repeals secs. 391 through 395 of the Code)—effective date of subchapter C

This section strikes out the effective date provisions of subchapter C of chapter 1 of subtitle A. These provisions are not needed for transactions occurring after the effective date of the repeal (i.e., taxable years beginning after December 31, 1975).

Subchapter D. Deferred compensation, etc.

Sec. 1901(a)(57) (amends sec. 401 of the Code)—relating to requirements for qualification of certain retirement plans

Subparagraphs (A), (B), and (C) replace references to "the date of enactment of the Employee Retirement Income Security Act of 1974" or to "enactment of the Employee Retirement Income Security Act of 1974" with that date of enactment (September 2, 1974). Subparagraph (D) corrects an error in margination.

Sec. 1901(a)(58) (amends sec. 402 of the Code)—taxability of beneficiary of employees' trust

Subparagraph (A) replaces an obsolete citation and it replaces four references to "basic salary" by references to "basic pay", in conforming Code provisions relating to Civil Service retirement laws to changes in those laws made by Public Law 89–554 in 1966.

Subparagraph (B) deletes from the Code subsection (d) of section 402, an absolete provision pertaining to certain trust agreements made before October 21, 1942.

Subparagraph (C) amends section 402(e)(4)(A) to make clear the intent of Congress in enacting the Employee Retirement Income Security Act of 1974 that the distribution of an annuity contract is not in and of itself to be treated as a taxable lump sum distribution, although the value of the contract can affect the amount of tax imposed on account of distributions of other property. This amendment is made retroactive to the effective date of the lump sum distribution taxation provisions of the 1974 Act.

Sec. 1901(a)(59) (amends sec. 403 of the Code)—rollover of employee annuities

This provision corrects an error in margination made in ERISA.

Sec. 1901(a)(60) (amends sec. 404 of the Code)—certain deductions for contributions to a pension plan

This provision repeals section 404(d), which permits limited carryovers of certain pension plan contribution deductions from 1939 Code years to 1954 Code years if the carryover deductions would have been allowable if the 1939 Code provisions had remained in effect. It is believed that any such eligible carryovers have by now been used or lost.

Sec. 1901(a)(61) (repeals sec. 406 of the Code)—retirement plan coverage of special employees of foreign subsidiaries

This provision repeals section 406 of the Code, which is no longer necessary because of the addition to the Code of section 410(b)(2)(C) by ERISA. Section 406 provides that United States citizens who are employees of a foreign subsidiary may be covered under the domestic corporation's retirement plan. Now that section 410(b)(2)(C) provides that nonresident aliens of foreign subsidiaries need not be considered in determining whether a retirement plan fails to qualify for tax exemption because of discrimination in favor of officers, shareholders, or highly compensated employees, United States employees of foreign subsidiaries may be placed in special qualified plans. Therefore, they need no longer be included in the domestic corporation's plan.

Sec. 1901(a)(62) (amends sec. 409 of the Code)—rollover contributions from individual retirement accounts or individual retirement annuities

This provision corrects a typographical error in ERISA.

Sec. 1901(a)(63) (amends sec. 410 of the Code)—minimum participation standards

Subparagraph (A) is a clerical amendment to conform to current drafting style. Subparagraph (B) substitutes "September 2, 1974," for "the date of enactment of the Employee Retirement Income Security Act of 1974". Subparagraph (C) substitutes "September 1, 1974" for "the day before the date of the enactment of this section".

Sec. 1901(a)(64) (amends sec. 411 of the Code)—minimum vesting standards

Subparagraph (A) makes a change in wording to conform to current drafting style. Subparagraph (B) in three places substitutes September 2, 1974, for references to the date of enactment of ERISA. Subparagraph (C) corrects a typographical error in a heading. Subparagraph (D) also twice substitutes September 2, 1974, for references to the date of enactment of ERISA. Subparagraph (E) substitutes "September 1, 1974" for a reference to the day before the date of enactment of ERISA.

Sec. 1901(a)(65) (amends sec. 442 of the Code)—minimum funding standards

Subparagraph (A) substitutes "September 1, 1974" for a reference to the day before the date of enactment of ERISA. Subparagraph (B) substitutes "September 2, 1974" for a reference to the date of enactment of ERISA.

Sec. 1901(a)(66) (amends sec. 414 of the Code)—definitions and special rules

Subparagraph (A) corrects a typographical error in ERISA. Subparagraph (B) substitutes "September 2, 1974" for a reference to the date of enactment of ERISA.

Sec. 1901(a)(67) (amends sec. 415 of the Code)—limitations on benefits and contributions under qualified plans

These amendments correct clerical errors in ERISA.

Subchapter E. Accounting periods and methods of accounting

Sec. 1901(a)(68) (amends sec. 453 of the Code)—installment method

Subparagraph (A) is a clerical amendment substituting a reference to the 1954 Code for an erroneous reference to the 1939 Code.

Subparagraph (B) corrects a grammatical error by striking the words "or section" which improperly appear in a list of Code sections.

Sec. 1901(a)(69) (amends sec. 455 of the Code)—prepaid subscription income

This amendment strikes out an obsolete effective date provision (taxable years beginning after December 31, 1957) relating to an election to have section 455 of the Code apply to certain prepaid subscription income of the taxpayer.

Sec. 1901(a)(70) (amends sec. 465 of the Code)—prepaid dues income of certain membership organizations

This amendment deletes an obsolete effective date provision (taxable years beginning after December 31, 1960) relating to an election to have section 456 of the Code apply to certain prepaid dues income of the taxpayer.

Sec. 1901(a)(71) (amends sec. 461 of the Code)—general rule for taxable year of deduction

Subparagraph (A) deletes the obsolete transitional rule relating to deduction by an accrual basis taxpayer of real property taxes deductible under the Internal Revenue Code of 1939 or deductible for the taxpayer's first taxable year which began after December 31, 1953.

Subparagraph (B) deletes an obsolete effective date provision (taxable years beginning after December 31, 1953) relating to an election with respect to the deduction of real property taxes by a taxpayer using an accrual method of accounting.

Sec. 1901(a)(72) (amends sec. 481 of the Code)—adjustments required by changes in method of accounting

These amendments delete special provisions which provide that certain adjustments attributable to pre-1954 Code years resulting from a change in method of accounting be taken into account over a 10-year period beginning with the year of change. These provisions do not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963, and are therefore obsolete.

Sec. 1901(a)(73) (amends sec. 508 of the Code)—special rules for certain exempt organizations

Subparagraph (A) strikes provisions stating that the time for new organizations to give the required notice to the Secretary regarding section 501(c)(3) status and private foundation status shall not expire before the 90th day after the day on which regulations first prescribed under section 508 (a) and (b) become final. Those regulations became final on December 21, 1972.

Subparagraph (B) deletes a special rule for private foundations organized before January 1, 1970. This rule applies to taxable years beginning before January 1, 1972. Subparagraph (C) is a conforming amendment to the changes made by subparagraph (B).

Sec. 1901(a)(74) (amends sec. 514 of the Code)—unrelated debt-financed income

Subparagraph (A) strikes out a transitional rule that applied to taxable years beginning before January 1, 1972.

Subparagraph (B) strikes out the lengthy definitions of "business lease" and "business lease indebtedness". These definitions are needed only in connection with a rule of limited application set forth in section 514(b)(3)(C)(iii) and in the rule deleted by subparagraph (A). These definitions are replaced in subparagraph (C) with an appropriate reference to prior law.

Subparagraph (D) strikes the term "premises" from a definitional section because that term is no longer used in section 514.

Subchapter G. Corporations used to avoid income tax on shareholders

Sec. 1901(a)(75) (amends sec. 534 of the Code)—burden of proof with respect to the accumulated earnings tax

These amendments delete the obsolete transitional rules providing for the retroactive application of the 1954 Code burden of proof requirement with respect to the accumulated earnings tax to proceedings involving 1939 Code years.

Sec. 1901(a)(76) (amends sec. 535 of the Code)—accumulated taxable income

This amendment strikes out a reference to 1939 Code excess profits taxes that have been repealed.

Sec. 1901(a)(77) (amends sec 537 of the Code)—reasonable needs of the business

These amendments strike out an internal effective date provision (May 26, 1969) relating to the definition of excess business holdings redemption needs.

Sec. 1901(a)(78) (amends sec. 542 of the Code)—definition of personal holding company

Subparagraph (A) strikes out a provision that prevents certain exempt organizations from being treated as individuals for purposes of the personal holding company definition. The provision applies only if the organization owned all of the corporation's common stock and 80 percent of its other stock at all times on or after July 1, 1950. It is likely that these corporations have been liquidated since 1955, when this provision was enacted, because income from investments would be taxable if held in such a corporation but would be tax-free if held by the exempt organization directly.

Subparagraph (B) amends a provision limiting the ability of a consolidated group to compute its personal holding company tax on a consolidated basis. The amendment strikes out an exception for groups of railroad corporations that would be eligible to file a consolidated return under the provisions of the 1939 Code before its amendment in 1942. It appears that this exception is no longer needed, since it would apply only to a group of railroad corporations that files consolidated returns and meets the five-or-fewer-shareholders test.

Subparagraph (C) amends a cross reference to conform to the amendment of section 7701(a)(19) by the Tax Reform Act of 1969.

Subparagraph (D) adds a U.S. Code citation to conform to current practice.

Sec. 1901(a)(79) (amends sec. 545 of the Code)—undistributed personal holding company income

Subparagraph (A) strikes out a reference to repealed 1939 excess profits taxes. It also eliminates a provision permitting a personal holding company that deducted taxes on the cash basis during 1939 Code years to continue to do so until it makes an irrevocable election to use the accrual basis. It seems unlikely that a significant number of companies have not elected to accelerate their deductions by using the accrual basis.

Subparagraph (B) strikes out a provision allowing the deduction of amounts used or set aside to retire indebtedness incurred before 1934. It seems likely that virtually all of this indebtedness has now been retired.

Subparagraph (C) strikes out "the date of enactment of this subsection" in section 545(c)(2)(A) and substitutes the exact date (February 26, 1964).

Sec. 1901(a)(80) (amends sec. 547 of the Code)—deduction for deficiency dividends

This amendment deletes a 1954 Code effective date provision that is no longer needed.

Sec. 1901(a)(81) (amends sec. 551 of the Code)—foreign personal holding companies

This clerical amendment inserts a word ("income") erroneously omitted from this section.

Sec. 1901(a)(82) (amends sec. 556 of the Code)—undistributed foreign personal holding company income

This amendment deletes a reference to 1939 Code excess profits taxes that have been repealed.

Sec. 1901(a)(83) (amends sec. 564 of the Code)—dividend carryover

This amendment strikes out a transitional provision relating to dividend carryovers from pre-1954 Code years for purposes of computing the dividends paid deduction of a personal holding company.

Subchapter H. Banking institutions

Sec. 1901(a)(84) (repeals sec. 583 of the Code)—deductions of dividends paid on certain preferd stock

This amendment strikes out provisions relating to deductions of dividends paid on certain preferred stock by banks or trust companies. It appears that none of this stock is now outstanding and that these provisions are no longer needed.

Sec. 1901(a)(85) (repeals sec. 592 of the Code)—deduction for repayment of certain loans

This paragraph repeals the provision allowing certain mutual savings banks to deduct certain repayments of pre-September 1, 1951, loans. All the loans described in the section have been repaid and therefore the provision is no longer applicable.

Sec. 1901(a)(86) (amends sec. 593 of the Code)—reserves for losses on loans

Subparagraph (A) strikes out the applicable percentages to be used by mutual savings banks in computing the addition to reserves for bad debts under the percentage of taxable income method for years 1969 through 1975.

Subparagraph (B) deletes the obsolete portions of paragraphs (2) through (5) of section 593(c), which deal with the required allocation of the bad debts reserves of mutual savings banks on December 31, 1962.

Subparagraphs (C) and (D) strike out a transitional rule for a taxable year beginning in 1962 and ending in 1963 that deals with the treatment of bad debts reserves of mutual savings banks and make an internal conforming change.

Sec. 1901(a)(87) (repeals sec. 601 of the Code)—special deduction for bank affiliates

This paragraph repeals a special deduction allowed bank affiliates in computing the accumulated earnings tax and the personal holding company tax. The deduction is for the amount of earnings and profits required to be invested in a reserve of readily marketable assets under the Banking Act of 1933. This requirement was eliminated in 1966, and there is now no requirement that such a reserve be maintained.

Subchapter I. Natural resources

Sec. 1901(a)(88) (amends sec. 613A of the Code)—depletion for oil and natural gas from secondary or tertiary processes

Subparagraph (A) eliminates a reference to a subparagraph of the Code that was deleted by Public Law 94–12, the Tax Reduction Act of

1975 (sec. 613(b)(1)(A) of the Code). The present section 613(b)(1)(A) was, prior to that act, section 613(b)(1)(B).

Subparagraph (B) also corrects a clerical error in that Act.

Sec. 1901(a)(89) (amends sec. 614 of the Code)—definition of property

These amendments strike out complex and seldom used provisions relating to recapture of taxes saved by delaying an election to aggregate mineral properties from the date of first exploration to the date of development of the mine.

Sec. 1901(a)(90) (repeals sec. 615 of the Code)—pre-1970 exploration expenditures

This amendment repeals section 615 of the Code, which provided a deduction for certain mineral exploration expenditures paid or incurred before January 1, 1970. Although a taxpayer could elect under section 615(b) to defer the deduction of such pre-1970 expenditures until the units of produced ores or minerals discovered by reason of such expenditures were sold, it is believed that no such elections are in effect.

Conforming amendments include the addition of a new subsection (i) to section 617 of the Code. This new subsection (i) preserves the rules (formerly set forth in section 615(g)(2)), which provide that amounts deducted under section 615 with respect to mineral property by the transferor of such property will be subject to recapture by the transferee in certain circumstances under section 617.

Sec. 1901(a)(91) (amends sec. 617 of the Code)—deduction and recapture of certain mining exploration expenditures

This amendment strikes out a provision allowing the revocation without consent of an election if the revocation was made within 3 months after the month in which final regulations were published under section 617(a) of the Code. Such regulations were published on June 30, 1972, so this provision is no longer needed.

Sec. 1901(a)(92) (repeals sec. 632 of the Code)—maximum tax on sales of certain oil or gas properties

This amendment strikes out a provision (sec. 632) which limits to 32 percent the tax on sales of oil or gas properties the principal value of which has been demonstrated by prospecting or discovery done by the taxpayer himself. To qualify, the taxpayer must be an individual, not a corporation.

This provision was enacted in 1918 to encourage oil and gas development and to lower the tax rate on such a sale in view of the years that might be consumed in discovery work prior to such a sale. This provision was deleted in 1934, but reinstated in 1936 to encourage individuals in competition with corporations and because Congress believed that the 1934 deletion had discouraged sales of such properties.

Before 1969 this section was probably seldom used because the 25-percent alternative capital gain rate was lower than the maximum tax rate under section 632. In the Tax Reform Act of 1969, Congress increased the maximum capital gain tax rate for individuals to 35 percent. Congress did not then intend to create a preference rate which is less than the general maximum capital gain rate.

Subchapter J. Estates, trusts, beneficiaries, and dependents

Sec. 1901(a)(93) (repeals sec. 683 of the Code)—application of part I of estate and trust provisions

This provision repeals the obsolete effective date provisions for part I of subchapter J of chapter 1.

Sec. 1901(a)(94) (amends sec. 691 of the Code)—income in respect of decedents

This amendment strikes out a reference to an obsolete effective date provision (sec. 683 of the Code) which is repealed by section 1901(a)(93) of this title.

Sec. 1901(a)(95) (amends sec. 692 of the Code)—members of the Armed Forces dying during an induction period

This is a clerical amendment changing "on" to "of" in the heading of the section.

Subchapter K. Partners and partnerships

Sec. 1901(a)(96) (amends sec. 751 of the Code)—properties to be treated as unrealized receivables.

This amendment eliminates a clerical error which retained an unnecessary word ("or") in a listing of Code sections.

Sec. 1901(a)(97) (repeals sec. 771 of the Code)—effective date provision of subchapter K

This provision deletes the obsolete effective date provisions (generally, December 31, 1954) for subchapter K of chapter 1 (relating to partners and partnerships). The repeal of Code section 771(b)(1) (relating to adoption of taxable year) does not require any existing partner or partnership to change to a different taxable year or change his (or its) manner of reporting income. Thus, for example, if an existing partnership adopted a fiscal year beginning before April 2, 1954, and an individual who subsequently becomes a principal partner in that partnership adopts a taxable year that is different from that of the partnership, the repeal of section 771(b)(1) by the bill does not require either the principal partner or that partnership to change to the taxable year of the other.

Subchapter L. Insurance companies

Sec. 1901(a)(98) (amend sec. 802 of the Code)—tax on life insurance companies

Subparagraph (A) deletes an obsolete effective date provision (taxable years beginning after December 31, 1957) relating to the imposition of tax on a life insurance company.

Subparagraph (B) deletes an obsolete effective date provision (taxable years beginning after December 31, 1961) relating to the alternative tax in the case of capital gains of a life insurance company.

Subparagraph (C) deletes an obsolete special rule for computing the tax for a taxable year of a life insurance company beginning in 1959 or 1960.

Sec. 1901(a)(99) (amends sec. 804 of the Code)—taxable investment income

Subparagraph (A) strikes out a special rule which, in effect, provides for any adjustment necessary to prevent a life insurance company from being taxed on tax-exempt interest or dividends qualifying for a dividend received deduction. This special rule is surplusage because the basic life insurance company tax provisions have been held to prevent the imposition of tax on these items.

Subparagraph (B) strikes out an internal effective date provision (taxable years beginning after December 31, 1958) relating to the computation of life insurance company gross investment income.

Sec. 1901(a)(100) (amends sec. 805 of the Code)—policy and other contract liability requirements

Subparagraph (A) strikes out an obsolete provision pertaining to the earnings rate of life insurance companies for taxable years beginning before January 1, 1958.

Subparagraph (B) strikes out a parenthetical clause which provides that the adjusted basis of certain assets which a life insurance company must take into account in computing its taxable income is determined without regard to the fair market value of the assets on December 31, 1958. This clause was surplusage when enacted and continues to be surplusage since the adjusted basis of these assets is not affected by their fair market value on December 31, 1958.

Subparagraph (C) strikes out traditional rules, relating to the amount taken into account as pension plan reserves, for taxable years beginning after December 31, 1957, and before January 1, 1961.

Sec. 1901(a)(101) (amends sec. 809 of the Code)—gain and loss from operations

Subparagraph (A) strikes out a special rule which, in effect, provides for any adjustments necessary to prevent a life insurance company from being taxed on tax-exempt interest or dividends qualifying for a dividends received deduction. This special rule is surplusage because the basic life insurance company tax provisions have been held to prevent the imposition of tax on these items.

Subparagraphs (B) and (C) strike out obsolete provisions relating to certain deductions for distributions made during the period 1958 through 1962.

Sec. 1901(a)(102) (amends sec. 812 of the Code)—operations loss deduction

This amendment strikes out obsolete transitional rules relating to years before 1958 to which operating losses of a life insurance company could be carried. An obsolete internal effective date (taxable years beginning after December 31, 1958) is also deleted.

Sec. 1901(a)(103) (amends sec. 817 of the Code)—rules relating to certain gains and losses

These amendments strike out special rules relating to capital losses of life insurance companies incurred in taxable years beginning before January 1, 1959, and reinsurance transactions of life insurance companies occurring in 1958.

Sec. 1901(a)(104) (amends sec. 818 of the Code)—accounting provisions

This amendment deletes transitional rules applicable to changes in a life insurance company's method of accounting from its taxable year 1957 to its taxable year 1958.

Sec. 1901(a)(105) (amends sec. 819 of the Code)—foreign life insurance companies

Subparagraph (A) strikes out a transitional rule for taxable years beginning before January 1, 1959.

Subparagraphs (B) and (C) make internal conforming amendments.

Sec. 1901(a)(106) (amends sec. 820 of the Code)—optional treatment of certain reinsurance policies

These amendments delete an obsolete provision relating to a life insurance company's treatment of a reimbursement of Federal income tax for a taxable year beginning before 1958.

Sec. 1901(a)(107) (amends sec. 821 of the Code)—tax on mutual insurance companies

Subparagraphs (A) and (B) strike out obsolete internal effective dates (taxable years beginning after December 31, 1963) relating to the imposition of tax.

Subparagraph (C) strikes out an obsolete transitional rule for taxable years beginning after December 31, 1962, and before January 1, 1968 relating to underwriting losses of mutual insurance companies.

Sec. 1901(a)(108) (amends sec. 822 of the Code)—determination of taxable investment income

Subparagraph (A) strikes out an obsolete reference to tax-exempt income from obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer. No such obligations that pay tax-exempt interest are outstanding.

Subparagraph (B) strikes out an obsolete internal effective date (taxable years beginning after December 31, 1962) relating to accrual of discount on bonds.

Sec. 1901(a)(109) (amends sec. 825 of the Code)—unused loss deductions

These amendments strike out an obsolete transitional date (taxable years beginning before January 1, 1963) relating to taxable years to which or from which certain unused losses may be carried.

Sec. 1901(a)(110) (amends sec. 831 of the Code)—tax on certain insurance companies

This amendment makes a clerical change, changing the word "or" to "on".

Sec. 1901(a)(111) (amends sec. 832 of the Code)—insurance company taxable income

These amendments conform the name of the National Association of Insurance Commissioners by substituting "Association" for "Convention."

Subchapter M. Regulated investment companies and real estate investment trusts

Sec. 1901(a)(112) (amends sec. 851 of the Code)—definition of regulated investment company

Subparagraph (A) makes a clerical change to conform a citation to other citations in the Code.

Subparagraph (B) strike out an obsolete effective date (taxable years beginning after December 31, 1941) relating to the time for making an election to be a regulated investment company.

Sec. 1901 (a)(113) (amends sec. 852 of the Code)—taxation of regulated investment companies and their shareholders

Subparagraph (A) strikes out a special rule, relating to the deduction for dividends paid, that applies only to taxable years beginning before January 1, 1975.

Subparagraph (B) deletes a transitional rule relating to an adjustment of the basis of the shares of a shareholder of a regulated investment company based upon a percentage of the amount of undistributed capital gains includible in the shareholder's income. The amendment deletes provisions relating to taxable years beginning before January 1, 1971. A special rule is provided so that the amendment made by subparagraph (B) shall not be considered to affect the amount of any increase in the basis of stock under the provisions of section 853(b)(3)(B)(iii) of the Code which is based upon amounts subject to tax under section 1201 of the Code in taxable years beginning before January 1, 1975.

Subparagraph (C) adds a citation reference to the United States Code.

Sec. 1901(a)(114) (amends sec. 856 of the Code)—definition of real estate investment trust

Subparagraph (A) strikes out an obsolete internal effective date (taxable years beginning after December 31, 1960) relating to an election to be a real estate investment trust.

Subparagraph (B) inserts a citation reference to the United States Code.

Sec. 1901(a)(115) (amends sec. 857 of the Code)—taxation of real estate investment trusts and their beneficiaries

This amendment strikes out a special rule, relating to the determination of the deduction for dividends paid, for taxable years beginning before January 1, 1975.

Subchapter N. Tax based on income from sources within or without the United States

Sec. 1901(a)(116) (amends sec. 864 of the Code)—definitions

These amendments and conforming amendments change the terms "sale" and "sold" to "sale or exchange" and "sold or exchanged", respectively each place they appear in part I of subchapter N of chapter 1 of the Code. Definitions of the term "sale" as including "exchange" and "sold" as including "exchanged" are then eliminated from section 864.

Sec. 1901(a)(117) (amends sec. 904 of the Code)—limitation on foreign tax credit

Subparagraph (A) strikes out an obsolete clause limiting the election of the overall limitation to the foreign tax credit to taxable years beginning after 1960 and permitting taxpayers who had elected the overall limitation to revoke that election for their first taxable year beginning after December 31, 1969.

Subparagraph (B) strikes out the reference to the right to revoke the election for the first taxable year beginning after December 31, 1969, provided in subparagraph (A).

Subparagraph (C) strikes out provisions limiting carrybacks to years beginning after 1957 in cases of payments of foreign taxes in excess of the applicable foreign tax credit limitation.

Subparagraph (D) deletes obsolete 1962 transitional rules for carrybacks and carryforwards of foreign tax payments in excess of the applicable foreign tax credit limitation.

Sec. 1901(a)(118) (amends sec. 905 of the Code)—proof of foreign tax credits

This amendment deletes a special foreign tax credit rule relating to the treatment of taxes imposed by the United Kingdom with respect to scientific and industrial royalties. The treatment of these taxes is dealt with in the United States—United Kingdom income tax convention and accordingly the special Code provision is no longer necessary.

Sec. 1901(a)(119) (amends sec. 911 of the Code)—taxation of noncash remuneration from sources without the United States

This amendment strikes out obsolete rules dealing with certain noncash remuneration received in taxable years ending in 1963, 1964, or 1965.

Sec. 1901(a)(120) (amends sec. 921 of the Code)—Western Hemisphere Trade Corporations

This amendment strikes out an obsolete provision relating to the determination of whether corporations met certain requirements of the 1939 Code in taxable years beginning before January 1, 1954.

Sec. 1901(a)(121) (amends sec. 931 of the Code)—income from sources within United States possessions

These amendments strike out an obsolete provision relating to citizens who were captured by the Japanese in the Philippine Islands during World War II.

Sec. 1901(a)(122) (amends sec. 934 of the Code)—tax liability incurred to the Virgin Islands

This amendment strikes out a provision indicating that amounts received within the United States cannot be excluded from income by Virgin Island law pursuant to section 934. This was originally intended as a source of payment rule, but, as a result of misinterpretations, it no longer serves any purpose in tax law.

Sec. 1901(a)(123) (amends sec. 951 of the Code)—amounts included in gross income of United States shareholders

This amendment strikes out an obsolete effective date provision (taxable years beginning after December 31, 1962) for this section.

Sec. 1901(a)(124) (repeals sec. 972 of the Code)—consolidation of group of export corporations

This paragraph repeals the provision which allows the consolidation of export trade corporations for purposes of the exception from subpart F treatment (relating to certain income of controlled foreign corporations) which is provided for certain export-related income of these corporations. This provision has been little used in the past and is not currently being used.

Sec. 1901(a)(125) (amends sec. 981 of the Code)—election as to treatment of income subject to foreign community property laws

These amendments strike out an obsolete effective date provision (taxable years beginning after December 31, 1966) and delete special rules relating to elections with respect to certain foreign community income in taxable years beginning before January 1, 1967.

Subchapter O. Gain or loss on disposition of property

Sec. 1901(a)(126) (amends sec. 1001 of the Code)—determination of amount of and recognition of gain and loss

This amendment transfers to section 1001(c) of the Code the rules relating to recognition of gain or loss now in section 1002 of the Code. A conforming amendment repeals section 1002.

Sec. 1901(a)(127) (amends sec. 1015 of the Code)—basis of property acquired by gifts and transfers in trust

These amendments substitute "September 2, 1958" for the references to "the date of the amendment of the Technical Amendments Act of 1958" as the effective date of section 1015(d).

Sec. 1901(a)(128) (amends sec. 1016 of the Code)—adjustments to basis

This amendment deletes from the Code section 1016(a)(19), which requires adjustments in the basis of section 38 property in tax years beginning before 1965. To the extent future transactions involve property as to which taxpayers failed to make these pre-1965 basis adjustments, the repeal of section 1016(a)(19) does not prevent their doing so retroactively, at least for prospective application, since the law governing adjustment of basis is the law of the period during which the adjustment was required to be made. (See, e.g., Treas. Regs. § 1.1016–3(f).)

Sec. 1901(a)(129) (amends sec. 1018 of the Code)—adjustment of capital structure before September 22, 1938

This amendment strikes out an unnecessary citation.

Sec. 1901(a)(130) (repeals sec. 1020 of the Code)—election in respect of depreciation allowed before 1952

This amendment repeals an obsolete provision relating to an election to adjust the basis of property with respect to depreciation before 1952. No election could be made or revoked under this section after December 31, 1954. The adjustment under section 1016 of the Code to the basis of the property which was the subject of the election is not affected by prospective repeal of section 1020.

Sec. 1901(a)(131) (repeals sec. 1022 of the Code)—basis of certain foreign personal holding company stock

Section 1022 of the Code is repealed because it is an unimportant and seldom used provision. This provision was added to the Code for one case (in which it was not used). Section 1022 applies only with respect to the basis of stock or securities of a corporation which was a foreign personal holding company for its most recent taxable year ending before the death of a decedent dying after December 31, 1963, from whom such stock or securities are acquired. Although it is unlikely that this provision has ever been used, a special effective date is provided so that the repeal applies only with respect to stock or securities acquired from a decedent dying after the date of the enactment of this bill.

Sec. 1901(a)(132) (amends sec. 1023 of the Code)—cross references

This amendment strikes out an obsolete reference to the Defense Production Act of 1950.

Sec. 1901(a)(133) (amends sec. 1033 of the Code)—involuntary conversions

Subparagraph (A) strikes out an obsolete provision applicable to the conversion of property into money where the disposition of the converted property occurred before 1951.

Subparagraphs (B) and (D) conform sections 1033(a)(2) and (c) to the change made by subparagraph (A). Subparagraph (B) also makes a clerical change to include as new subparagraphs necessary definitions of "control" and "disposition of converted property" that would otherwise be deleted by the amendment made by subparagraph (A).

Subparagraph (C) strikes out an obsolete special rule relating to certain conversions of property before January 1, 1954.

Subparagraph (E) strikes out an obsolete effective date provision (December 31, 1957) relating to the disposition of certain property.

Sec. 1901(a)(134) (amends sec. 1034 of the Code)—sale or exchange of residence

Subparagraphs (A) and (B) strike out obsolete internal effective dates (December 31, 1954) relating to the sale of a residence.

Subparagraph (C) strikes out an obsolete reference to the Internal Revenue Code of 1939.

Subparagraph (D) strikes out obsolete transitional rules for the years 1951 through 1957.

Subparagraph (E) strikes out an internal effective date (December 31, 1950) which is no longer needed.

Sec. 1901(a)(135) (amends sec. 1037 of the Code)—certain exchanges of United States obligations

This amendment corrects an erroneous cross reference.

Sec. 1901(a)(136) (amends sec. 1051 of the Code)—property acquired during affiliation

This amendment strikes out the sentences in section 1051 that provide that the basis of property acquired or held during a consolidated return year is to be determined under the consolidated return regulations. This provision is unnecessary because adequate authority for providing basis rules in the consolidated return regulations is provided under section 1502 and its predecessors.

Sec. 1901(a)(137) (amends sec. 1081 of the Code)—distributions required by the Securities and Exchange Commission.

These amendments strike out a special rule for distributions of stock and rights to acquire stock before January 1, 1958, in pursuance of an order of the Securities and Exchange Commission.

Subparagraph (B) also conforms a citation to current practice.

Sec. 1901(a)(138) (amends sec. 1083 of the Code)—containing definitions of terms.

These amendments eliminate unnecessary citations.

Sec. 1901(a)(139) (repeals sec. 1111 of the Code)—distribution of stock pursuant to order enforcing the antitrust laws

This amendment and conforming amendments repeal special provisions relating to the income tax treatment of certain recipients of General Motors stock distributed pursuant to a court order in the *DuPont* anti-trust case (*United States* v. *E. I. duPont deNemours and Company, et al.*, 353 U.S. 586 (1957) and 365 U.S. 806 (1961)). Section 1111 of the Code provides special rules for individual shareholders and shareholders not entitled to the corporate dividends received deduction who receive such stock. Technical amendments relating to the addition of section 1111 were added to sections 301, 312, 535, 543, 545, 553, 556, and 561 of the Code. The distributions which are the subject of these provisions have been completed and the rights of persons who received such distributions are preserved. Accordingly, the bill repeals section 1111 of the Code and related provisions.

The repeal of these provisions is not retroactive. Nor do these repeals alter the determination, for purposes of future years, of the basis of stock with respect to which the distribution were made.

Subchapter P. Capital gains

Sec. 1901(a)(140) (amends sec. 1201 of the Code)—alternative tax on capital gains

Subparagraph (A) makes clerical amendments to eliminate references to "net section 1201 gain" in taking advantage of the new definition of "net capital gain" (sec. 1901(a)(141)(B) of this title. This subparagraph also deletes transitional rules for computing the capital gains tax for corporations before 1975. (The effective date rule of the bill will preserve rights and liabilities with respect to pre-1975 years so long as they are open under the statute of limitations.)

Subparagraph (B) also eliminates references to "net section 1201 gain" made obsolete by the new definition of "net capital gain." In addition, obsolete transitional rules for computing an individual's alternative capital gains tax in 1970 and 1971 are deleted.

Subparagraph (C) eliminates other transitional rules for noncorporate taxpayers with respect to years prior to 1975. That elimination, and a transfer to section 1201(b) of the rule limiting to 25 percent the alternative tax on the first $50,000 of net capital gain permits subsection (d) to be deleted.

Sec. 1901(a)(141) (amends sec. 1222 of the Code)—terms relating to capital gains and losses

Subparagraph (A) defines a new term, "capital gain net income," which replaces the former term "net capital gain." The new term, like the former term, refers to the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges (sec. 1222(9)).

Subparagraph (B) sets forth a new definition of "net capital gain". The term replaces the existing term, "net section 1201 gain," in section 1222(11). The new and former terms refer to the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. These definitions make it possible to use these terms throughout the Code instead of the longer phrases.

Sec. 1901 (a)(142) (amends sec. 1233 of the Code)—gains and losses from short sales

This amendment substitutes "August 16, 1954" for "the date of enactment of this title" as the effective date of section 1233(c).

Sec. 1901(a)(143) (amends sec. 1237 of the Code)—real property subdivided for sale

This amendment strikes out an obsolete effective date (December 31, 1953).

Sec. 1901(a)(144) (amends sec. 1239 of the Code)—again from sale of property between certain persons

This amendment strikes out an obsolete effective date (May 3, 1951) relating to the sale or exchange of property between spouses or between an individual and a controlled corporation.

Sec. 1901(a)(145) (repeals sec. 1240 of the Code)—taxability to employee of certain termination payments

This amendment repeals the so-called Louis B. Mayer provisions. This provision permits capital gain treatment of a lump sum settlement of rights in an employment contract. Since the provision contains narrow restrictions, including the requirement that the rights be created before August 16, 1954, it is believed that it has no applicability today.

Sec. 1901(a)(146) (amends sec. 1245 of the Code)—gain from dispositions of certain depreciable property

This amendment deletes surplus language added through a clerical error by Public Law 94–81.

Sec. 1901(a)(147) (amends sec. 1246 of the Code)—gain on foreign investment company stock

This amendment strikes out an obsolete effective date (December 31, 1962).

Subchapter Q. Readjustment of tax between years and special limitations

Sec. 1901(a)(148) (amends sec. 1311 of the Code)—mitigation of effect of limitations

These amendments conform section 1311 to the new name of the Tax Court.

Sec. 1901(a)(149) (repeals sec. 1315 of the Code)—effective date

This provision repeals the obsolete effective date provision (November 15, 1954) for part II of subchapter Q of chapter 1. An obsolete transitional rule relating to the application of the Internal Revenue Code of 1939 to certain determinations made before November 15, 1954, is also deleted.

Sec. 1901(a)(150) (repeals sec. 1321 of the Code)—involuntary liquidation of LIFO inventories

This paragraph repeals an obsolete provision relating to involuntary liquidations of LIFO inventories. The provision applies only to inventories liquidated in taxable years ending after June 30, 1950, and before January 1, 1955, and only if the inventory was replaced in a taxable year ending before January 1, 1956.

Sec. 1901(a)(151) (repeals sections 1331 through 1337 of the Code)—war loss recoveries

This provision repeals the provisions dealing with World War II war loss recoveries effective with respect to recoveries in taxable years beginning after December 31, 1976. The basis of property recovered during prior taxable years will not be affected by the repeal. Future recoveries, which appear unlikely, would be covered by the general tax benefit rule, which accords similar (though not identical) treatment.

Sec. 1901(a)(152) (amends sec. 1341 of the Code)—restoration of amount held under claim of right

This amendment strikes out provisions relating to certain retroactive payments by a subcontractor to a prime contractor, or by a subcontractor to a higher tier subcontractor. These provisions are expressly limited to payments made under a subcontract entered into before January 1, 1958, and it is believed that no such contracts are still outsanding.

Sec. 1901(a)(153) (repeals sec. 1342 of the Code)—computation of tax on certain amounts recovered as a result of a patent infringement suit

This paragraph repeals special provisions relating to amounts taken into gross income because of the reversal of a lower court decision in a patent infringement suit. Because of the narrow circumstances in which this provision applies (e.g., the lower court decision must be reversed on the ground that such decision was induced by fraud or undue influence), this provision is rarely used.

Sec. 1901(a)(154) (repeals sec. 1345 of the Code)—recovery of unconstitutional Federal taxes

This provision repeals special provisions, no longer needed, relating to the treatment of a recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional.

Sec. 1901(a)(155) (amends sec. 1348 of the Code)—maximum tax rate on earned income

Paragraphs (1) and (2) of section 1348(a) are amended to correct a technical error by replacing references to "the lowest amount of taxable income on which the rate of tax under section 1 exceeds 50 percent" with references to "the highest amount of taxable income on which the rate of tax is not more than 50 percent." In addition, subparagraph (B) strikes out obsolete transitional rules that relate to taxable years beginning in 1971.

Subchapter S. Election of certain small business corporations as to taxable income

Sec. 1901(a)(156) (amends sec. 1372 of the Code)—election by small business corporation

Under the minimum tax provisions of the Tax Reform Act of 1969, an electing small business corporation is subject to tax on certain capital gains. The amendment made by subparagraph A conforms section 1372 to these provisions by inserting a reference to the tax imposed by section 56 of the Code.

Subparagraph (B) strikes out a transitional rule, relating to the time for making an election by a small business corporation, that applies to a taxable year beginning in 1958.

Subparagraph (C) strikes out a special rule that allowed certain shareholders who owned stock that was community property to file a consent prior to May 15, 1961, to an election by a small business corporation.

Sec. 1901(a)(157) (amends sec. 1374 of the Code)—net operating losses of electing small business corporations

These amendments repeal an obsolete rule relating to carrybacks to years before 1958 of the net operating loss of an electing small business corporation, by striking out section 1374(d). A rule of current application now in section 1374(d)(1) is transferred to section 1374(b).

Sec. 1901(a)(158) (amends sec. 1375 of the Code)—special rules applicable to distributions of electing small business corporations

Subparagraph (A) provides a new heading for subsection 1375(b) to reflect the fact that individuals no longer receive a dividends received credit.

Subparagraph (B) strikes out a reference to a subsection of section 1375 that was eliminated in 1966 by Public Law 89–389.

Sec. 1901(a)(159) (amends sec. 1378 of the Code)—tax imposed on certain capital gains of electing small business corporations

This amendment strikes out a provision relating to the determination of the tax with respect to certain capital gains of an electing small business corporation for certain taxable years beginning before January 1, 1975.

Subchapter T. Cooperatives and their patrons

Sec. 1901(a)(160) (amends sec. 1388 of the Code)—patronage dividends

Subparagraph (A) strikes out "the date of the enactment of the Revenue Act of 1962" and substitutes the exact date, "October 16, 1962".

Subparagraph (B) strikes out "the date of the enactment of this subsection" and substitutes the exact date, "November 13, 1966".

Chapter 2. Tax on Self-Employment Income

Sec. 1901(a)(161) (amends sec. 1401 of the Code)—self-employment taxes

Subparagraph (A) deletes obsolete rules providing rates of self-employment tax (for old age, survivors, and disability insurance) for taxable years that began before 1973. Similarly, subparagraph (B) strikes out obsolete rules providing rates of self-employment tax for hospital insurance for taxable years that began prior to 1975. (However, the current rate of hospital insurance self-employment tax for years beginning in 1974 and ending in 1975 would be preserved through the operation of the effective date of this title.)

Sec. 1901(a)(162) (amends sec. 1402 of the Code)—definitions relating to the tax on self-employment income

Subparagraph (A) deletes provisions relating to the determination of self-employment income for taxable years beginning before January 1, 1975, that are no longer needed.

Subparagraph (B) deletes an obsolete provision relating to the treatment of certain remuneration erroneously reported as net earnings from self-employment for taxable years ending after 1954 and before 1962.

Subparagraph (C) strikes out a special rule which allowed a request for an exemption from the tax on self-employment income for a taxable year ending before December 31, 1967, to be filed on or before December 31, 1968. The general rule provides that such request must be filed by the due date of the return for the first taxable year in which the individual has self-employment income.

Chapter 3. Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenants

Sec. 1901(a)(163) (repeals sec. 1465 of the Code)—definition of withholding agent

This section repeals section 1465, which defines "withholding agent," since that term is defined in section 7701(a)(16).

Chapter 4. Rules Applicable to Recovery of Excessive Profits on Government Contracts

Sec. 1901(a)(164) (amends sec. 1481 of the Code)—mitigation of effect of renegotiation of government contracts

These amendments update section 1481 by deleting obsolete references to the Sixth Supplemental National Defense Appropriation Act and to the Renegotiation Act of 1948.

Chapter 6. Consolidated Returns

Sec. 1901(a)(165) (amends sec. 1551 of the Code)—disallowance of surtax exemption and accumulated earnings credit

This amendment corrects an erroneous cross reference.

Sec. 1901(a)(166) (amends sec. 1552 of the Code)—earnings and profits of members of an affiliated group

This amendment deletes the effective date for this provision ("taxable years beginning after December 31, 1953, and ending after the date of enactment of this title".)

Sec. 1901(b)—conforming and clerical amendments

Section 1901(b) of the bill makes a series of clerical and conforming amendments required by the amendments and repeals made by subsection 1901(a) of this title.

Sec. 1901(c)—amendments to provisions referring to Territories

This subsection of the bill strikes out references to "Territories" in Code sections 37, 105, 117, 162, 273, 581, 801, 861, 1014, and 1221. The United States no longer has any Territories.

In general these amendments are not intended to affect rights existing under present law that were conferred because of Code provisions regarding Territories.

Sec. 1901(d)—effective date

This subsection of the bill provides that unless otherwise expressly provided the amendments made by section 1901 of this title shall apply with respect to taxable years beginning after December 31, 1976.

SEC. 1902. AMENDMENTS OF SUBTITLE B; ESTATE AND GIFT TAXES

Chapter 11. Estate Tax

Sec. 1902(a)(1) (amends sec. 2001 of the Code)—rate of the estate tax

This amendment strikes out an internal effective date (relating to decedents dying after August 16, 1954, the date of enactment of the Internal Revenue Code of 1954) which is no longer needed.

Sec. 1902(a)(2) (amends sec. 2012 of the Code)—credit for gift tax

These amendments provide headings for several subsections and paragraphs in this section and also substitute a comma for a dash in conforming to generally accepted drafting style.

Sec. 1902(a)(3) (amends sec. 2013 of the Code)—credit for tax on prior transfers

These amendments strike out obsolete references to prior laws.

Sec. 1902(a)(4) (amends sec. 2038 of the Code)—revocable transfers

This amendment strikes out a provision of limited application which is no longer needed. (The provision relates to a decedent who has been under a mental disability for a continuous period since September, 1947, and has been unable to relinquish certain powers to alter or revoke an interest in property transferred by him.)

Sec. 1902(a)(5) (amends sec. 2055 of the Code)—transfers for public, charitable, and religious use

Subparagraph (A) strikes out a provision of limited application which is no longer needed. This provision deals with highly unique circumstances involving a bequest in trust, the income from which is payable for life to the decedent's surviving spouse (who must be over 80 years old at the decedent's death) if such surviving spouse has a power of appointment over the corpus of such trust exercisable by will in favor of, among others, certain charitable, religious, scientific, literary, or educational organizations. No part of the corpus of such trust may be distributed to a beneficiary during the life of such surviving spouse and the surviving spouse must execute an affidavit within 6 months after the decedent's death specifying the organizations in favor of whom the power will be exercised (and the amount or proportion each is to receive). If the power of appointment is exercised in accordance with such affidavit, then the bequest in trust, reduced by the value of the life estate, shall, to the extent the power is exercised in favor of such organizations, be deemed a transfer to those organizations by the decedent.

Subparagraph (B) strikes out several cross references that are no longer applicable and updates the remaining cross references.

Sec. 1902(a)(6) (amends sec. 2101 of the Code)—property held by alien property custodian

This amendment strikes out an unnecessary citation.

Sec. 1902(a)(7) (amends sec. 2106 of the Code)—taxable estate

Subparagraph (A) strikes out several cross references which are no longer necessary.

Subparagraph (B) strikes out a provision that excludes from the taxable estate obligations issued by the United States before March 1, 1941, if held by a decedent who was not engaged in business in the United States at the time of his death. It is believed that no obligations issued by the United States before March 1, 1941, are still outstanding.

Sec. 1902(a)(8) (amends sec. 2107 and sec. 2108 of the Code)—estate tax on expatriates and application of pre-1967 estate tax provisions

These amendments substitute "November 13, 1966" for "the date of enactment of this section" as the effective date of these provisions.

Sec. 1902(a)(9) (relates to sec. 2201 of the Code)—members of the Armed Forces dying during an induction period

In Public Law 93-597, section 6(b)(1) thereof provided for the amendment of section 2210 of the Code. There was no section 2210 of the Code, nor is there such a section now. The amendment was intended to be to section 2201 of the Code. This paragraph of the amendment corrects Public Law 93-597.

Sec. 1902(a)(10) (repeals sec. 2202 of the Code)—missionaries in foreign service

The bill repeals section 2202 of the Code, which provides that missionaries dying in missionary service will be presumed to die as United States residents, even if they intended to remain permanently in foreign service. This provision is now unnecessary since the Foreign Investors Tax Act of 1966 increased the estate tax exemption of nonresidents from $2,000 to $30,000.

Sec. 1902(a)(11) (amends sec. 2204 of the Code)—discharge of fiduciary from personal liability

This amendment corrects a typographical error in the Excise, Estate, and Gift Tax Adjustment Act of 1970.

Chapter 12. Gift Tax

Sec. 1902(a)(12) (amends sec. 2501 of the Code)—imposition of gift tax

This amendment strikes out an internal effective date (the first calendar quarter of 1971) which is no longer needed.

Sec. 1902(a)(13) (amends sec. 2522 of the Code)—cross references

This amendment strikes out a list of cross references which also appears in section 2055(f) of the Code and inserts in lieu of such list a reference to section 2055(f).

Sec. 1902(a)(14) (amends secs. 2011, 2016, 2053, 2055, 2056, 2106, 2522, and 2523 of the Code)—Territories

These sections are each amended by striking out references to Territories because there are no longer any United States Territories. Hawaii, admitted to Statehood in 1958, was the last Territory. There are United States territories (in which instances the word "territory" is begun with a small letter "t"), of which American Samoa is an example. In contrast to Territories, territories are unincorporated.

Sec. 1902(b)—conforming amendments

This subsection of the bill makes conforming amendments to the table of sections for subchapter C of chapter 11, and to sections 6503 (e) and 6167(h)(2) of the Code to reflect the repeal of section 2202 and the amendment of section 2055 of the Code.

Sec. 1902(c)—effective dates

This subsection provides that the amendments made by paragraphs (1) through (10), and paragraphs (14) (A), (B), and (C) of subsection (a), as well as by subsection (b), shall apply in the case of estates of decedents dying after the date of enactment of the bill, and the amendment made by paragraph (11) of subsection (a) shall apply in the case of estates of decedents dying after December 31, 1975. The amendments made by paragraphs (12), (13), and (14) (D) and (E) of subsection (a) shall apply to gifts made after December 31, 1976.

SEC. 1903. AMENDMENTS OF SUBTITLE C; EMPLOYMENT TAXES

Chapter 21. Federal Insurance Contributions Act

Sec. 1903(a)(1) (amends secs. 3101 and 3111 of the Code)—rates of tax on employees and employers

Subparagraph (A) strikes out the employment tax rates for employees and employers for calendar years before 1975. These rates are not effective for calendar years after 1974.

Subparagraph (B) strikes out the pre-1975 tax rates on employers and employees for hospital insurance for the same reason.

Sec. 1903(a)(2) (repeals sec. 3113 of the Code)—application of social security tax to District of Columbia Credit Unions

This amendment repeals a provision relating to credit unions that were chartered under the Act of June 23, 1932. No credit unions are now chartered under that Act. District of Columbia Credit Unions are now Federal Credit Unions and as such are subject to section 3121 (b)(6)(B)(ii) of the Code.

Sec. 1903(a)(3) (amends sec. 3121 of the Code)—employment tax definitions

Subparagraph (A) strikes out a reference to the Internal Revenue Code of 1939 that is no longer needed, and also eliminates an obsolete internal effective date provision ("service performed after 1954,").

Subparagraphs (B) and (D) eliminate unnecessary citations.

Subparagraph (C) changes the term "Secretary of the Treasury" to "Secretary of Transportation" in a provision pertaining to the Coast Guard. The Coast Guard is now within the Department of Transportation.

Subparagraph (E) deletes provisions allowing certain exempt organizations which filed certificates before 1966 or between 1955 and August 28, 1958 (relating to social security coverage for their employees), to amend the certificate to advance its effective date, or to request that the effective date be advanced, if the amendment was made before 1967, or if the request was made before 1960, respectively.

Subparagraphs (F) and (G) strike out obsolete effective dates (January 1, 1955, and December 1956) relating to agreements entered into by domestic corporations with respect to certain social security coverage for employees of foreign subsidiaries and to service performed as a member of the uniformed services, respectively.

Sec. 1903(a)(4) (amends sec. 3122 of the Code)—Federal service

These amendments change references to the "Secretary of the Treasury" to the "Secretary of Transportation" in provisions relating to the Coast Guard, since the Coast Guard is now part of the Department of Transportation.

Sec. 1903(a)(5) (amends sec. 3125 of the Code)—returns in the case of certain governmental employees

This is a clerical amendment changing "Commissioners of the District of Columbia" to "Mayor of the District of Columbia" in order to conform to the District of Columbia Self Government and Governmental Reorganization Act.

Chapter 22. Railroad Retirement Tax Act

Sec. 1903(a)(6) (amends sec. 3201 of the Code)—rate of tax on railroad employees

These amendments strike out an effective date (September 30, 1973) relating to the imposition of taxes with respect to services performed after that date, and delete references to the Internal Revenue Code of 1954 which are not needed.

Sec. 1903(a)(7) (amends sec. 3202 of the Code)—deductions of tax from compensation

Subparagraph (A) strikes out an internal effective date (September 30, 1973), relating to the performance of services by employees after that date and also deletes references to the Internal Revenue Code of 1954 which are not needed.

Subparagraph (B) makes a clarifying change in language with respect to indemnification of an employee.

Sec. 1903(a)(8) (amends. sec. 3211 of the Code)—rate of tax on employee representatives

These amendments correct a grammatical error, delete references to the Internal Revenue Code of 1954 which are not needed, and strike out an obsolete effective date (September 30, 1973).

Sec. 1903(a)(9) (amends sec. 3221 of the Code)—rate of tax on employers

Subparagraphs (A) and (B) strike out an internal effective date (September 30, 1973), relating to the imposition of taxes with respect to services performed after that date, and also delete references to the Internal Revenue Code of 1954, which are no longer needed.

Subparagraph (C) deletes references to rates of tax applicable for services rendered before April 1, 1970.

Sec. 1903(a)(10) (amends sec. 3231 of the Code)—definitions

This amendment deletes unnecessary Statutes at Large citations.

Chapter 23. Federal Unemployment Tax Act

Sec. 1903(a)(11) (amends sec. 3301 of the Code)—Federal unemployment tax rate

These amendments strike out an internal effective date (calendar year 1970) and the tax rate with respect to wages paid during calendar year 1973, which are no longer needed.

Sec. 1903(a)(12) (amends sec. 3302 of the Code)—credits against tax

Subparagraphs (A) and (B) strike out references to special transitional rules relating to the 10-month period ending October 31, 1972, which are deleted by sections 1903(a)(14)(B) and 1903(a)(13) of this title.

Subparagraph (C)(i) strikes out a transitional provision relating to a limitation on credits against the unemployment tax if a State has not yet repaid an advance under certain prior laws. This provision is no longer applicable since all the States have repaid the advances made under those laws.

Subparagraph (C)(ii) strikes out an internal effective date (the date of enactment of the Employment Security Act of 1960) which is no longer needed. Subparagraphs (C)(iii), (C)(iv), (C)(v), and (C)(vi) are in the nature of amendments conforming to the amendment made by subparagraph (C)(i).

Subparagraph (D) strikes out a cross reference to a 1958 statute (the Temporary Unemployment Compensation Act of 1958) which is no longer applicable.

Sec. 1903(a)(13) (amends sec. 3303 of the Code)—conditions of additional credit allowance

This amendment deletes a transitional rule (from provisions relating to a finding by the Secretary of Labor with respect to certain State unemployment funds) for the 10-month period ending October 31, 1972.

Sec. 1903(a)(14) (amends sec. 3304 of the Code)—approval of State laws

Subparagraph (A) deletes an unnecessary citation. Subparagraph (B) eliminates a transitional rule regarding the 10-month period ending October 31, 1972.

Sec. 1903(a)(15) (amends sec. 3305 of the Code)—applicability of State law

Subparagraphs (A) and (B) strike out an obsolete effective date (July 1, 1953) which relates to service performed on or after that date.

Subparagraph (C) strikes out an obsolete effective date (December 31, 1971), relating to taxes imposed with respect to taxable years after that date.

Sec. 1903(a)(16) (amends sec. 3306 of the Code)—definitions

Subparagraphs (A), (B), and (C) strike out unnecessary citation references and insert a reference to the United States Code.

Subparagraph (D) strikes out an obsolete effective date (July 1, 1953) relating to services performed on or after such date.

Chapter 24. Collection of Income Tax at Source on Wages

Sec. 1903(a)(17) (amends sec. 3402 of the Code)—income tax collected at the source

This paragraph is a clerical amendment to correct an erroneous cross reference.

Sec. 1903(b)—conforming amendment

This amendment conforms the table of sections for subchapter (B) of chapter 21 to the repeal of section 3113.

Sec. 1903(a)—amendments to provisions relating to Territories

This amendment strikes out references to Territories in sections 3401 and 3404 of the Code because there are no more Territories of the United States.

Sec. 1903(d)—effective date

The amendments made b y section 1903 of the bill are to apply with respect to wages paid after December 31, 1976, except that the amendments made to chapter 22 of the Code are to apply with respect to compensation paid for services rendered after December 31, 1975.

SEC. 1904. AMENDMENTS OF SUBSTITUTE D; MISCELLANEOUS TAXES

Chapter 31. Retailers Excise Taxes

Sec. 1904(a)(1) (amends chapter 31 of the Code)—retailers excise taxes

Subparagraph (A) changes the title of chapter 31 from "Retailers Excise Taxes" to "Special Fuels" and strikes out obsolete tables of subchapters and sections since the whole chapter, as revised, will now have only one section.

Subparagraph (B) incorporates into section 4041(g) (relating to exemptions from fuel taxes) the existing provisions for exemptions from fuel taxes for State and local governments, sales for export or shipment to possessions, and nonprofit educational organizations now founa in sections 4055, 4056, and 4057 of the Code. Code sections 4055, 405ʊ, and 4057 are repealed by subparagraph (D) of this subsection of tne bill.

Subparagraph (C) amends section 4041 of the Code by adding a new subsection (i) which incorporates the provisions of existing Code section 4054 (relating to sales by the United States). Section 4054 is repealed by subparagraph (D) of this subsection of the bill.

Subparagraph (D) repeals Code section 4042 (a cross reference), 4054, 4055, 4056, 4057 (the substance of which has been incorporated in Code sections 4041(i) and 4041(g)(2), (3), and (4), respectively), and 4058 (a cross reference).

Chapter 32. Manufacturers Excise Taxes

Sec. 1904(a)(2) (amends sec. 4216 of the Code)—definition of price

This paragraph is a clerical amendment redesignating subsections (e), (f), and (g) as subsections (d), (e), and (f), respectively. The previous subsection (d) was repealed in 1958.

Sec. 1904(a)(3) (amends sec. 4217 of the Code)—leases

This amendment strikes out a transitional rule for leases entered into before January 1, 1959, that are treated as sales subject to manufacturers excise taxes.

Sec. 1904(a)(4) (repeals sec. 4226 of the Code)—floor stock taxes

This provision repeals floor stock tax provisions relating to specified items held in dealers' stocks on various past dates, the most recent of which are tires and tubes held by manufacturers' retail outlets on October 1, 1966.

Sec. 1904(a)(5) (amends sec. 4227 of the Code)—cross references

This amendment deletes two unnecessary cross references.

Chapter 33. Facilities and Services

Sec. 1904(a)(6) (amends sec. 4253 of the Code)—exemptions from the tax on communications services

This amendment transfers to section 4253 of the Code (relating to exemptions) provisions for exemptions for communications services provided by section 4292 of the Code for State and local governments and by section 4294 for nonprofit educational organizations. Sections 4292 and 4294 are repealed by sections 1904(a) (9) and (10) of this title.

Sec. 1904(a)(7) (amends sec. 4261 of the Code)—tax on transportation of persons by air

This amendment strikes out references to an obsolete internal effective date (June 30, 1970).

Sec. 1904(a)(8) (amends sec. 4271 of the Code)—tax on transportation of property by air

This amendment also strikes out a reference to the obsolete internal effective date of June 30, 1970.

Sec. 1904(a)(9) (repeals sec. 4292 of the Code)—exemption for State and local governments from the communications services tax

This amendment repeals the provisions relating to exemption of State and local governments from the tax on communications services. These provisions are transferred to section 4253 of the Code by section 1904(a)(6) of this title. Section 4253 is devoted to exemptions from the communications services tax.

Sec. 1904(a)(10) (repeals sec. 4294 of the Code)—exemption for nonprofit educational organizations

This amendment deletes the provisions conferring exemption from the tax on communications services to nonprofit educational organizations. These provisions are transferred by subsection 1904(a)(6) to section 4253 of the Code, which is devoted to exemptions from this tax.

Sec. 1904(a)(11) (repeals sec. 4295 of the Code)—cross reference

This amendment repeals an unnecessary cross reference.

Chapter 34. Documentary Stamp Taxes

Sec. 1904(a)(12) (amends chapter 34 of the Code)—documentary stamp taxes

This amendment changes the title of chapter 34 of the Code from "Documentary Stamp Taxes" to "Policies Issued by Foreign Insurers", strikes out obsolete tables of subchapters and sections, and revises the remaining provisions.

Section 4371 of the Code is amended to conform to the fact that the tax imposed by that section is now paid by return and not by stamp. Section 4372 is amended to include the pertinent provisions of present section 4382(a)(1) and to make internal conforming amendments.

New Code section 4373 corresponds to the present section 4373, except for the deletion of an obsolete reference to Territories.

New Code section 4374 corresponds to present Code section 4384 except that it is changed to reflect payment by return rather than by stamp.

Present Code sections 4374, 4375, 4382, and 4383 are repealed to reflect the change from stamps to returns and to reflect the repeal in 1965 of other documentary stamp taxes.

Present Code sections 4361, 4362, and 4363, relating to a tax on conveyances which expired on January 1, 1968, are repealed.

Chapter 36. Certain Other Excise Taxes

Sec. 1904(a)(13) (amends sec. 4493 of the Code)—certain persons engaged in foreign air commerce

These amendments strike out an internal effective date (July 1, 1970) relating to an election to pay a tentative tax with respect to taxable civil aircraft. They also strike out a transitional rule for a year beginning on July 1, 1970.

Chapter 37. Sugar, Coconut and Palm Oil

Sec. 1904(a)(14) (amends chapter 37 of the Code)—tax on sugar, coconut and palm oil

This amendment changes the title of chapter 37 from "Sugar, Coconut and Palm Oil" to "Sugar" to reflect the repeal in 1962 of taxes on coconut and palm oil. Obsolete tables of subchapters are also deleted.

Chapter 38. Import Taxes

Sec. 1904(a)(15) (repeals secs. 4591 through 4597 of the Code)—import taxes on oleomargarine

This provision strikes out provisions relating to taxes on imported oleomargarine. Requirements as to wholesomeness and purity are enforced by the Food and Drug Administration outside the requirements of the Internal Revenue Code. No taxes are collected under these provisions and at present they serve no internal revenue purpose. Since the other subchapters of this chapter were repealed in 1962, the entire chapter is now repealed.

Chapter 39. Regulatory Taxes

Sec. 1904(a)(16) (repeals secs. 4801 through 4806 of the Code)—tax on white phosphorous matches

This provision repeals provisions relating to taxes on white phosphorous matches. Any act taxable under these provisions is illegal under other provisions of Federal law and these provisions are not needed for effective enforcement. No tax is collected under these provisions.

Sec. 1904(a)(17) (repeals secs. 4811 through 4826 of the Code)—tax on adulterated butter

This amendment strikes out the tax on adulterated butter and related provisions. Requirements as to wholesomeness and purity of butter are enforced by the Food and Drug Administration outside the provisions of the Code. No taxes are collected as to adulterated butter. This tax dates from the 1890's, when it served the dual function of restricting trade in this item and insuring purity (e.g., restricting the use of rancid butter). At present, the tax and related provisions serve no internal revenue purpose. Appropriate regulation of commerce can be accomplished in other provisions of law.

Sec. 1904(a)(18) (repeals secs. 4881 through 4886 of the Code)—tax on circulation other than of national banks

This paragraph repeals provisions relating to circulation of other than national banks. The Comptroller of the Currency has stated that any act taxable under these provisions is also illegal under other provisions of Federal law and that these provisions are not needed for effective enforcement. No tax is collected under these provisions.

Chapter 40. General Provisions Relating to Occupational Taxes

Sec. 1904(a)(19) (amends sec. 4901 of the Code)—payment of occupational taxes

This amendment strikes out an obsolete provision relating to payment of certain occupational taxes by stamp, since all taxes to which this provision applies are paid by return.

Sec. 1904(a)(20) (amends sec. 4905 of the Code)—liability for occupational taxes in case of death or change in location

Section 4905 of the Code allows the wife (but not husband) of a decedent who paid a certain occupational tax before his death to carry on the same trade or business for the residue of the term for which the tax was paid without liability for additional tax. This amendment substitutes "spouse" for "wife" in this provision so that a widower will have the same privilege as a widow.

Chapter 41. Interest Equalization Tax

Sec. 1904(a)(21) (repeals secs. 4911 through 4931 of the Code)—interest equalization tax

This paragraph repeals provisions relating to the interest equalization tax, since this tax does not apply to acquisitions of stock and debt obligations made after June 30, 1974. A special effective date is provided so that the repeal of chapter 41 (Code section 4911 through 4931) is to apply only with respect to acquisitions of stock and debt obligations made after June 30, 1974 (or to loans and commitments made after that date). Thus the rights and obligations of persons with respect to acquisitions of stock and debt obligations prior to July 1, 1974, are preserved.

Chapter 42. Private Foundations

Sec. 1904(a)(22) (amends sec. 4942 of the Code)—taxes on failure to distribute income

These amendments strike out a rule relating to the determination of minimum investment return with respect to private foundations that is applicable only to taxable years beginning in 1970 and delete a related internal effective date (taxable years beginning after 1970) which is no longer needed.

Chapter 43. Qualified Pension, Etc., Plans

Sec. 1904(a)(23) (amends sec. 4973 of the Code)—tax on excess contributions to certain retirement plans

Subparagraph (A) corrects an error in margination. Subparagraph (B) corrects an erroneous reference. Both these errors were clerical errors in ERISA.

Sec. 1904(b)—conforming amendments

This subsection of the bill makes various conforming amendments to the amendments and repeals made by subsection (a). These amendments include repeal of several Code sections that relate to violations of laws and other offenses concerning oleomargarine or adulterated butter (Code sections 7234 and 7265), white phosphorus matches (Code sections 7239, 7267, 7274, and 7328), and adulterated butter and process or renovated butter (Code sections 7235 and 7264). Amendments conforming to the repeal of chapter 41 of the Code (relating to interest equalization taxes) include the repeal of Code sections 263(a)(3) and (d) (relating to the deduction of interest equalization taxes), 6011(d), 6076, 6651(e), 6680 (which relate to the filing requirements for interest equalization tax returns), 6611(h) (relating to interest on overpayments of interest equalization tax), 6681, 7241 (relating to false or fraudulent equalization tax certificates), and 6689 (relating to failure by certain foreign issuers and obligors to comply with United States investment equalization tax requirements).

The amendments conforming to the repeal of chapter 41 have various effective date provisions to assure that rights and liabilities (both civil and criminal) of taxpayers or other persons with respect to acquisitions of stock or indebtedness before July 1, 1974 (or certain actions with respect to such acquisitions), are not affected. Thus, for example, if a taxpayer is required to file an interest equalization tax return with respect to an acquisition of stock prior to July 1, 1974, and has failed to file such return, the repeal of section 6011(d) of the Code by this bill will not affect the requirement that such a return be filed.

Sec. 1904(c)—amendments to provisions referring to Territories

Subsection (c) amends Code sections 4102 and 4482(c)(1) by striking out references to Territories because the United States has no more Territories.

Sec. 1904(d)—effective date

Subsection (d) provides that the amendments made by section 1904 (except as otherwise provided) shall take effect on the first day of the first month which begins more than 90 days after the date of enactment of the bill.

SEC. 1905. AMENDMENTS OF SUBTITLE E; ALCOHOL, TOBACCO, AND CERTAIN OTHER EXCISE TAXES

Chapter 51. Distilled Spirits, Wines, and Beer

Subchapter A. Gallonage taxes

Sec. 1905(a)(1) (amends sec. 5005 of the Code)—persons liable for tax on distilled spirits

This amendment strikes out provisions relating to an internal effective date (July 1, 1959) which are no longer needed.

Sec. 1905(a)(2) (amends sec. 5008 of the Code)—abatement, etc., of tax on distilled spirits in instances of loss or destruction

Present law provides relief (under sec. 5008) from the distilled spirits tax of section 5001 for voluntary destruction of the spirits on bonded premises or before the spirits are removed from the bottling premises. In instances of spirits already removed from bonded premises, tax relief is provided, under certain defined circumstances, for accidental destruction within the distilled spirits plant. Finally, tax relief is provided if spirits that have been withdrawn from bond (with tax determination or payment) are thereafter returned to the bonded premises for certain purposes specified in section 5215.

Because of a technical error, this relief is now provided only for the tax imposed on domestic distilled spirits under section 5001 or other provisions of Chapter 51 of the Code. Puerto Rico and Virgin Island spirits are taxed separately (under sec. 7652). A technical correction is included in the bill to give the same type of tax relief to Puerto

Rican or Virgin Island spirits as is now given for domestic spirits. This amendment also strikes out an obsolete internal effective date (July 1, 1959).

Sec. 1905(a)(3) (amend sec. 5009 of the Code)—drawback of tax

This amendment deletes a redundant citation.

Sec. 1905(a)(4) (amends sec. 5025 of the Code)—exemption from rectification tax

This amendment permits stabilization (without payment of rectification tax) preparatory to export, thereby giving distilled spirits to be exported the same treatment, in this instance, as is given to distilled spirits preparatory to bottling.

Sec. 1905(a)(5) (amends sec. 5054 of the Code)—stamps and other devices as evidence of payment of tax on beer

This amendment strikes out a beer stamp provision that has never been implemented and for which there is no intention of implementation.

Sec. 1905(a)(6) (amends sec. 5061 of the Code)—method of collecting tax

Subparagraph (A) strikes out a stamp tax requirement that is now obsolete in that the taxes to which it applies are now all paid by return.

Subparagraph (B) strikes out authority to use stamps, coupons, tickets, or tax-stamp machines as alternative methods of collecting alcohol taxes since those methods neither have been implemented nor are to be implemented. The amendment also provides that taxes on illegal items are to be due and payable immediately at the time given in the provisions imposing the taxes, or (if no specific time is provided) when the event referred to in the provision occurs, and that these taxes are to be assessed and collected in accordance with the rules regarding taxes payable by return but for which no return has been filed.

Subparagraph (C) strikes out a provision no longer needed because it applies only to the unusual methods of collection stricken from the statute by subparagraph (B). In its place is substituted a provision making it clear that the gallonage taxes on distilled spirits, rectification, wines, and beer are generally imposed in addition to import duties. This conforms to the Tariff Schedules.

Sec. 1905(a)(7) (amends sec. 5113 of the Code)—sales to limited retail dealers

This amendment conforms to section 1905(a)(10) of this title (amending section 5122(c) of the Code), which permits a limited retail dealer to deal in distilled spirits, as well as in wine and beer.

Sec. 1905(a)(8) (amends sec. 5117 of the Code)—prohibited purchases by dealers

This amendment provides that a limited retail dealer may now purchase distilled spirits from a retail dealer in liquors. This is another change in the nature of an amendment conforming to section 1905(a)(10) of the bill.

Sec. 1905(a)(9) (amends sec. 5121 of the Code)—imposition and rate of tax on retail dealers

This paragraph provides that a limited retail dealer in distilled spirits is to pay a special (occupational) tax of $4.50 per calendar month. This amendment is necessitated by the broadening of the definition of "limited retail dealer" in section 1905(a)(10) of this title to include limited retail dealers in distilled spirits.

Sec. 1905(a)(10) (amends sec. 5122 of the Code)—definition of limited retail dealer

This provision expands the definition of a limited retail dealer to include a limited retail dealer in distilled spirits, as well as in wine and beer.

Sec. 1905(a)(11) (amends sec. 5131 of the Code)—drawback of tax in event of nonbeverage uses

Section 5131 of the code permits drawback of distilled spirits tax if the spirits are put to cited nonbeverage uses. Section 5131 requires the spirits thus used, to be eligible for the drawback, to have been produced in a domestic registered distillery or industrial alcohol plant and withdrawn from bond, or to be spirits withdrawn from the bonded premises of a distilled spirits plant. Domestic distilled spirits used for the cited nonbeverage purposes must necessarily have been produced in a domestic registered distillery or industrial alcohol plant. Spirits so used may also have been imported or brought into the United States, but, if so, they need first have been transferred to the bonded premises of a distilled spirits plant before withdrawal for the nonbeverage uses. This amendment deletes the unnecessary requirement that spirits "imported" or "brought into" the United States must first be transferred to the bonded premises of a distilled spirits plant.

Sec. 1905(a)(12) (amends sec. 5142 of the Code)—payment of taxes

This amendment replaces existing provisions that occupational taxes be paid by stamp with a requirement that they be paid by return. These taxes are now, in fact, being paid by return, as is required by Treasury regulations. This amendment also makes it clear that the tax on stills and condensers imposed by section 5101 is to be paid by return.

Subchapter B. Qualification requirements for distilled spirits plants

Sec. 1905(a)(13) (amends sec. 5171 of the Code)—permits for distilled spirits plants

This amendment eliminates a transitional rule relating to the time in which qualified distillers, bonded warehousemen, rectifiers, and bottlers of distilled spirits doing business as such on June 30, 1959, could obtain the required permit to continue in business. In addition, a redundant citation is deleted.

Sec. 1905(a)(14) (amends sec. 5174 of the Code)—withdrawal bonds

This paragraph allows a proprietor of bottling premises to withdraw distilled spirits which have been bottled in bond to his bottling premises under his withdrawal bond. The change would permit greater convenience in handling of bottled in bond cased goods and allow the same tax payment procedures applicable to spirits bottled and cased on bottling premises to be applied to bottled in bond cased goods.

Subchapter C. Operation of distilled spirits plants

Sec. 1905(a)(15) (amends sec. 5232 of the Code)—transfer of distilled spirits from outside the United States

Under section 5314 of the Code, distilled spirits brought into the United States from Puerto Rico or the Virgin Islands are not treated as "imported," but rather as "brought into" the United States.

The first sentence of section 5232 of the Code permits spirits imported or brought into the United States in bulk containers to be withdrawn from customs custody and transferred to the bonded premises of a distilled spirits plant without payment of the internal revenue tax. The second sentence then transfers the liability for eventual payment of the tax from the "importer" to the operator of the distilled spirits plant. In order to coordinate the two sentences, this amendment amplifies the second sentence to extend relief from tax liability to persons who have brought such spirits into the United States.

Sec. 1905(a)(16) (amends sec. 5233 of the Code)—relating to bottling requirements

This amendment eliminates a redundant citation.

Sec. 1905(a)(17) (amends sec. 5234 of the Code)—consolidation for further storage in bond

This amendment conforms the time limit within which distilled spirits in bond storage may be mingled with the time limit in section 5006(a)(2) for storing distilled spirits in bond. The latter limit was raised from eight years to twenty years in 1958.

Subchapter E. General provisions relating to distilled spirits

Sec. 1905(a)(18) (amends sec. 5314 of the Code)—application of certain provisions to Puerto Rico

This provision corrects an erroneous cross reference.

Sec. 1905(a)(19) (repeals sec. 5315 of the Code)—status of certain distilled spirits on July 1, 1959

This paragraph repeals a July 1, 1959, transitional provision.

Subchapter F. Bonded and taxpaid wine premises

Sec. 1905(a)(20) (amends sec. 5368 of the Code)—gauging and marking wine

Subparagraph (A) eliminates a reference to stamps in the heading of section 5368 since stamps are not used to identify wines and the use of stamps is not contemplated.

Subparagraph (B) removes a reference to stamps in section 5368 (b) and in the heading of that subsection.

Sec. 1905(a)(21) (amends sec. 5392 of the Code)—definitions relating to taxation of wine

This amendment strikes out a citation that is redundant and unnecessary.

Subchapter J. Penalties, seizures, and forfeitures relating to liquors

Sec. 1905(a)(22) (amends sec. 5601 of the Code)—presumptions relating to criminal penalties

This amendment strikes out paragraphs (1), (3), and (4) of present section 5601(b)—presumptions which either have been specifically declared unconstitutional or which the Internal Revenue Service believes to be unconstitutional.

Sec. 1905(a)(23) (amends sec. 5685 of the Code)—penalties for possession of certain devices

This paragraph conforms cross references and a definition to changes in chapter 53 made by the Gun Control Act of 1968.

Chapter 52. Cigars, Cigarettes, and Cigarette Papers and Tubes

Sec. 1905(a)(24) (amends sec. 5701 of the Code)—rate o' tax on imported tobacco products

This amendment conforms the tax on imported tobacco products and cigarette tubes and papers to Tariff Schedule item 804, 19 U.S.C. 1202, which provides, for articles previously exported from the United States, a customs duty "in lieu of any other duty or tax".

Sec. 1905(a)(25) (amends sec. 5703 of the Code)—liability for tobacco tax and method of payment

Subparagraph (A) conforms provisions relating to tobacco tax to administrative practice and to related provisions regarding wines and distilled spirits.

Subparagraph (B) strikes out a traditional rule allowing tobacco taxes to continue to be paid by stamp until regulations provide for payment on the basis of return. Those regulations have been issued, and so the transitional rule no longer applies.

Subparagraph (C) eliminates section 5703(c), relating to the use of stamps to evidence payment of the tobacco tax. These stamp provisions have never been implemented, and there is no intention to implement them.

Sec. 1905(a)(26) (amends sec. 5704 of the Code)—tobacco products, etc., brought into or returned to the United States

This amendment relaxes an unneeded restriction by permitting proprietors of export warehouses to import, under bond, tobacco products and cigarette papers and tubes directly, rather than through a tobacco products manufacturers, as is required by present law.

Sec. 1905(a)(27) (amends sec. 5712 of the Code)—tobacco business permits

This paragraph deletes an obsolete transitional rule allowing persons lawfully in business as a tobacco products manufacturer or as a tobacco export warehouse proprietor to remain in business after enactment of the Excise Tax Technical Changes Act of 1958 until he has had a reasonable opportunity to obtain the tobacco permit required by that Act.

Sec. 1905(a)(28) (amends sec. 5723 of the Code)—packaging tobacco prior to removal

This amendment strikes out a requirement that a tobacco products manufacturer or a tobacco export warehouse proprietor must affix to his package of tobacco products, etc., prior to removal, such stamps as regulations may prescribe. The use of stamps to evidence payment of the tobacco tax is being eliminated by the repeal of section 5703(c) of the Code by section 1905(a)(25)(C) of this title. Conforming changes are made to the headings of section 5723 and 5723(b).

Sec. 1905(b)—conforming and clerical amendments

This subsection provides various conforming amendments to reflect the amendments and repeals made in the alcohol, tobacco, etc., excise tax provisions (subtitle E).

Sec. 1905(c)—amendments to provisions referring to Territories

This subsection strikes out a number of references to "Territories" in the alcohol, tobacco, etc., tax provisions for the reason that there are no longer any "Territories" of the United States, Hawaii, which ceased to be a Territory in 1958, was the last. The United States does have a number of territories" (spelled with a beginning small letter "t"), but they have never been affected by these provisions. Deletion of these references does not terminate the rights, duties, powers, and liabilities that arose before the effective date of this title.

Sec. 1905(d)—effective date

This subsection provides that the effective date of the amendments and repeals made to subtitle E is to be the first day of the first month beginning more than 90 days after enactment of this title.

SEC. 1906. AMENDMENTS OF SUBTITLE F; PROCEDURE AND ADMINISTRATION

Chapter 61. Information and Returns

Sec. 1906(a)(1) (amends sec. 6013 of the Code)—joint returns

These amendments are clerical, such as the one which uses the new name of the United States Tax Court.

Sec. 1906(a)(2) (amends sec. 6015 of the Code)—estimated tax

This amendment strikes out an obsolete effective date provision (December 31, 1954) for this section.

Sec. 1906(a)(3) (amends sec. 6037 of the Code)—returns of subchapter S corporations

This amendment corrects an error in a cross reference.

Sec. 1906(a)(4) (amends sec. 6046 of the Code)—information as to organization of foreign corporations

This amendment eliminates special rules (relating to information returns with respect to foreign corporations) applicable to the first six months of 1963.

Sec. 1906(a)(5) (amends sec. 6051 of the Code)—receipts for employees

This is a clerical amendment striking out a misplaced word.

Sec. 1906(a)(6) (amends sec. 6065 of the Code)—verification of returns

This amendment eliminates the authority to require certain returns, statements, and other documents to be verified by oaths, rather than under the penalty of perjury. This authority is not now used and is not expected to be used.

Sec. 1906(a)(7) (amends sec. 6103 of the Code)—publicity of tax returns

This amendment strikes out a reference to coconut and palm oil taxes which were repealed in 1962. A special effective date provision is provided so that returns made or required to be made prior to that effective date will remain open to public inspection pursuant to section 6103.

Sec. 1906(a)(8) (repeals sec. 6105 of the Code)—compilation of data for certain excess profits cases

This amendment strikes out a provision for the compilation and publication of data with respect to excess profits tax cases under section 722 of the 1939 Code.

Sec. 1906(a)(9) (amends sec. 6110 of the Code)—cross reference

This amendment strikes out cross references to a provision relating to cotton futures (see section 1952 of this title) and to provisions relating to narcotics which were repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Chapter 62. Time and Place for Paying Tax

Sec. 1906(a)(10) (amends sec. 6152 of the Code)—installment payments by corporations

This amendment strikes out a rule for taxable years ending before December 31, 1954, which allowed a corporation to pay taxes imposed by chapter 1 in four installments.

Sec. 1906(a)(11) (amends sec. 6154 of the Code)—installment payments of estimated income tax by corporations

These amendments strike out various transitional rules applicable to installments of estimated tax for taxable years beginning in 1968, 1969, 1970, 1971, 1972, 1973, and 1974.

Sec. 1906(a)(12) (amends sec. 6157 of the Code)—payment of Federal unemployment tax quarterly or on other basis

These amendments strike out special rules relating to the computation of Federal unemployment tax for calendar quarters or other periods in 1970 and 1971.

Sec. 1906(a)(14) (amends sec. 6166 of the Code)—extension of time for payment of tax on the liquidation of certain personal holding companies

This amendment repeals a section dealing with an extension of time for the payment of tax on gain on the liquidation before 1957 of certain personal holding companies.

*Sec. 1906*A*a) (14) (amends sec. 6166 of the Code)—extension of time for payment of estate tax*

These amendments eliminate a 1958 effective date provision and strike out section 6166(i)(4), a special provision relating to taxable years ending before 1960.

Chapter 63. Assessment

Sec. 1906(a)(15) (amends sec. 6205 of the Code)—relating to the District of Columbia as an emp'oyer

This is a clerical amendment changing "Commissioner of the District of Columbia" to "Mayor of the District of Columbia" in order to reflect the enactment of the District of Columbia Self Government and Governmental Reorganization Act.

Sec. 1906(a)(16) (amends sec. 6027 of the Code)—cross references

The amendment strikes out a cross reference to provisions repealed in 1962.

Sec. 1906(a)(17) (amends sec. 6213 of the Code)—restrictions applicable to deficiencies; petitions to the Tax Court

This amendment conforms the provision to the definition of "United States", used in a geographical sense, that appears in section 7701 (a)(9) of the Code.

Sec. 1906(a)(18) (amends sec. 6215 of the Code)—assessment of deficiency found by Tax Court

This amendment strikes out an unnecessary citation.

Chapter 64. Collection

Sec. 1906(a)(19) (amends sec. 6302 of the Code)—collection of certain excise taxes

This is a clerical amendment to strike out references to certain obsolete provisions relating to taxes on coconut and palm oil (repealed in 1962) and on narcotics (repealed in 1970).

Sec. 1906(a)(20) (repeals sec. 6404 of the Code)—collection under the Tariff Act of 1930

This amendment repeals a cross reference to provisions repealed in 1962.

Sec. 1906(a)(21) (amends sec. 1336 of the Code)—fractional parts of a cent

This amendment deletes a reference to taxes payable by stamp from the rules pertaining to rounding off fractional parts of a cent in the payment of taxes, since no tax now collected by stamp will be due in fractions of a cent.

Sec. 1906(a)(22) (amends sec. 6326 of the Code)—cross references for sections relating to lien for taxes

This provision conforms to current drafting style in striking out unnecessary Statutes at Large citations in paragraphs 2, 3, 4, and 5.

Sec. 1906(a)(23) (amends sec. 6365 of the Code)—definitions and special rules

This amendment changes the term "Commissioner of the District of Columbia" to "Mayor of the District of Columbia" to reflect the provisions of the District of Columbia Self Government and Governmental Reorganization Act.

Chapter 65. Abatements, Credits, and Refunds

Sec. 1906(a)(24) (amends sec. 6412 of the Code)—floor stocks refunds

This is a clerical amendment which renumbers two paragraphs.

Sec. 1906(a)(25) (amends sec. 6413 of the Code)—special rules applicable to employment taxes

Subparagraphs (A) and (C) are clerical amendments substituting "Mayor" for "Commissioners" of the District of Columbia to reflect enactment of the District of Columbia Self Government and Governmental Reorganization Act.

Subparagraph (B) is a clerical amendment to reflect an increase in the social security wage base ceiling and to strike out certain rules applicable to special refunds or credits of certain employment taxes deducted from wages received in calendar years prior to 1975. A special effective date is provided so that refunds or credits with respect to wages paid in calendar years before 1976 will not be affected.

Subparagraph (D) strikes out an obsolete internal effective date (1967).

Sec. 1906(a)(26) (amends sec. 6416 of the Code)—refund or credit of taxes on special fuels

Subparagraph (A) is a clerical correction redesignating two subparagraphs in section 6416(a)(3).

Subparagraph (B) deletes provisions relating to credits or refunds of overpayments of taxes imposed on taxable sales or uses under section 4041 of the Code, but ultimately used or resold for exempt purposes (such as a use on a farm for farming purposes). These deleted provisions relate only to uses or resales prior to July 1, 1970. Exempt uses or resales after June 30, 1970, are covered by section 6427 of the Code.

Section 6416 of the Code allows a credit to be taken "on any subsequent return" for a number of overpayments, including those described in the deleted provisions of section 6416. It is possible, therefore, that claims for overpayments on account of sales and uses prior to July 1, 1970, may still be open, and, accordingly, the bill provides a special effective date for the deletions made in subparagraph (B) to preserve any such claims that may still be open.

Sec. 1906(a)(27) (repeal of sec. 6417 of the Code)—coconut and palm oil

This amendment strikes out a section of the Code relating to the former tax on coconut and palm oil that was repealed in 1962.

Sec. 1906(a)(28) (amends sec. 6420 of the Code)—gasoline used on farms

Subparagraph (A) deletes obsolete provisions concerning claims for refund with respect to gasoline used before July 1, 1965.

Subparagraph (B) corrects a typographical error.

Subparagraphs (C) and (D) strike out obsolete effective date provisions (December 1, 1955, and June 30, 1965).

Sec. 1906(a)(29) (amends sec. 6421 of the Code)—gasoline used for nonhighway purposes or by local transit systems

Subparagraph (A) strikes out an obsolete internal effective date (June 30, 1970).

Subparagraph (B) deletes obsolete provisions relating to claims for refund with respect to gasoline used before July 1, 1965.

Subparagraphs (C) and (D) strike out obsolete internal effective dates (June 30, 1956, and June 30, 1965).

Sec. 1906(a)(30) (amends sec. 6422 of the Code)—cross references relating to credits and refunds

This amendment deletes unnecessary citations to the Statutes at Large.

Sec. 1906(a)(31) (amends sec. 6423 of the Code)—credit or refund of alcohol and tobacco taxes

These amendments delete obsolete internal effective dates (April 30, 1958, April 30, 1969, and June 15, 1957) relating to claims for credit or refund and suits filed with respect to alcohol and tobacco taxes.

Sec. 1906(a)(32) (amends sec. 6424 of the Code)—lubricating oil not used in highway motor vehicles

These amendments strike out a transitional rule for taxable years beginning in 1965 and an obsolete internal effective date (December 31, 1965) relating to the use of certain lubricating oil.

Sec. 1906(a)(33) (amends sec. 6427 of the Code)—fuels not used for taxable purposes

These amendments strike out an obsolete effective date (June 30, 1970) relating to repayment or credit of the tax on use of certain fuels.

A special effective date for this provision ("fuel used or resold after June 30, 1970") is provided because credits and refunds for fuels used or resold prior to June 1, 1970, are governed by section 6416(b) of the Code.

Chapter 66. Limitations

Sec. 1906(a)(34) (amends sec. 6504 of the Code)—cross references

Subparagraph (A) is a clerical amendment to combine several cross references into one paragraph. Subparagraph (B) renumbers the paragraphs of section 6504 of the Code in conformance with the amendment made by subparagraph (A) and the deletion of paragraphs (1), (6), and (7) by paragraphs (36)(C), (37)(C), and (39)(B) of section 1901(b) of this title.

Sec. 1906(a)(35) (amends sec. 6511 of the Code)—limitations on credit or refund

These amendments strike out obsolete internal effective date provisions (September 1, 1959, and December 31, 1965) relating to certain claims for credit or refund.

Chapter 67. Interest

Sec. 1906(a)(36) (amends sec. 6601 of the Code)—interest on underpayments

This amendment strikes out an obsolete reference to a provision of the 1939 Code relating to interest on estimated tax payments.

Chapter 68. Additions to the Tax, Additional Amounts, and Assessable Penalties

Sec. 1906(a)(37) (amends sec. 6654 of the Code)—payment of estimated income tax

This amendment strikes out an internal effective date (December 31, 1954) that is no longer needed.

Chapter 69. General Provisions Relating to Stamps

Sec. 1906(a)(38) (amends sec. 6802 of the Code)—supply and distribution of stamps

This paragraph is a clerical amendment substituting a period for a semicolon.

Sec. 1906(a)(39) (amends sec. 6803 of the Code)—accounting and safeguarding of stamps

These amendments redesignate subsections (b) (1) and (2) as subsections (a) and (b) (the previous subsection (a) having been repealed in 1972) and strike out an obsolete cross reference.

Chapter 70. Jeopardy, Bankruptcy, and Receiverships

Sec. 1906(a)(40) (amends sec. 6863 of the Code)—stay of collection of jeopardy assessments

This amendment strikes out an obsolete internal effective date (January 1, 1955) relating to a stay of sale of seized property pending a Tax Court decision.

Chapter 72. Licensing and Registration

Sec. 1906(a)(41) (amends sec. 7012 of the Code)—cross references

This amendment strikes out a cross reference to the tax on white phosphorous matches (which is repealed by section 1904(a)(16) of this title), corrects an erroneous cross reference, and renumbers the remaining subsections.

Chapter 73. Bonds

Sec. 1906(a)(42) (amends sec. 7103 of the Code)—cross references

This amendment strikes out cross references to taxes on oleomargarine, adulterated butter, filled cheese, opium for smoking, and white phosphorus matches repealed by sections 1904(a)(15), (16), and (17) of the bill and by legislation enacted in 1962, 1970, and 1974.

Chapter 75. Crimes, Other Offenses, and Forfeitures

Sec. 1906(a)(43) (amends sec. 7271 of the Code)—penalties for offenses relating to stamps

This amendment strikes out an obsolete provision relating to payment of certain taxes by stamp.

Sec. 1906(a)(44) (amends sec. 7272 of the Code)—penalty for failure to register

This amendment strikes out cross references to narcotics provisions which were repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Sec. 1906(a)(45) (amends sec. 7326 of the Code)—disposal of forfeited or abandoned property

These amendments correct an erroneous reference and redesignate subsection (c) as subsection (b), the previous subsection (b) having been repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Chapter 76. Judicial Proceedings

Sec. 1906(a)(46) (amends sec. 7422 of the Code)—civil actions for refund

These amendments strike out an obsolete internal effective date (June 15, 1942), relating to the effect of certain suits and Tax Court petitions filed after that date.

Sec. 1906(a)(48) (amends sec. 7427 of the Code)—cross references relating to proceedings by taxpayers

Unnecessary Statutes at Large citations are struck out in this amendment.

Sec. 1906(a)(48) (amends sec. 7448 of the Code)—annuities to widows and dependent childre nof Tax Court judges

These amendments eliminate a distinction in present law between male and female judges of the Tax Court, in respect of annuities to surviving family members of Tax Court judges. As now worded, section 7448 refers only to a widow (defined as a surviving wife) of a Tax Court judge, and similarly to a mother of issue of a judge's marriage. However, it appears that there is no continuing intent to deny equal protection to the surviving spouses of all Tax Court judges regardless of sex.

The bill eliminates any distinction based on sex and replaces the terms "widow", "widower", "surviving wife", "mother", "her", and "she" with the terms "surviving spouse", "parent", and "such spouse", as appropriate.

Sec. 1906(a)(49) (amends sec. 7471 of the Code)—employees of Tax Court

These amendments delete unnecessary Statutes at Large citations from subsections (a) and (b) of section 7471.

Sec. 1906(a)(50) (amends sec. 7476 of the Code)—declaratory judgments

This amendment makes a clerical correction in placing the material in subsection (a) that follows paragraph (2)(B) at the flush left margin. This is done to make it clear that that material refers to all of subsection (a), and not merely to subsection (a)(2).

Chapter 77. Miscellaneous Provisions

Sec. 1906(a)(51) (amends sec. 7502 of the Code)—timely mailing treated as timely filing

This paragraph is a clerical amendment changing a reference (relating to postmarks) from the "United States Post Office" to the "United States Postal Service" to reflect the enactment of the Postal Reorganization Act.

Sec. 1906(a)(52) (amends sec. 7507 of the Code)—exemption for insolvent banks

These amendments strike out an obsolete date (May 28, 1938) relating to assessment of certain taxes owed by insolvent banks.

Sec. 1906(a)(53) (amends sec. 7508 of the Code)—time for performing certain acts postponed by reason of war

These are clerical amendments changing the heading of section 7508 to refer to "service in a combat zone" and using the defined term "United States" (sec. 7701(a)(9) of the Code) to replace "States of the Union and the District of Columbia".

Sec. 1906(a)(54) (amends sec. 7509) of the Code)—expenditures by the Post Office Department

Subparagraphs (A), (B), and (C) are clerical amendments to use the term "United States Postal Service" in lieu of "United States Post Office" to reflect the enactment of the Postal Reorganization Act.

Subparagraph (D) eliminates a cross reference to a previously repealed subsection.

Chapter 78. Discovery of Liability and Enforcement of Title

Sec. 1906(a)(55) (amends sec. 7621 of the Code)—internal revenue districts

This amendment eliminates the term "Territory" since there are no longer any Territories.

Sec. 1906(a)(56) (repeals sec. 7641 of the Code)—supervision of operations of certain manufacturers

This provision repeals subchapter C of chapter 78, which contains administrative provisions relating to the taxes on filled cheese, oleomargarine, process or renovated butter, and white phosphorus matches. The taxes on these items are repealed by other provisions of the bill or have been repealed by prior law.

Sec. 1906(a)(57) (amends sec. 7652 of the Code)—shipments to the United States

These subparagraphs strike out obsolete provisions relating to payments to the Virgin Islands of taxes collected in 1955 and 1956.

Sec. 1906(a) (58) (amends sec. 7653 of the Code)—shipments from the United States

This amendment deletes a citation to the Statutes at Large.

Chapter 79. Definitions

Sec. 1906(a) (59) (amends sec. 7701 of the Code)—definitions

Subparagraph (A) defines the term "Secretary" to mean the Secretary of the Treasury or his delegate. (The term "Secretary" is currently defined as the "Secretary of the Treasury".) Subparagraph (A) also provides that the term "Secretary of the Treasury" means the Secretary of the Treasury, personally, not including any delegate.

Subparagraph (B) redefines the term "or his delegate" for purposes of the Internal Revenue Code. This term may include, for example, the Commissioner of Internal Revenue.

To make use of these new terms, subparagraph (A) of subsection (b) (14) of section 1906 of this title amends the Internal Revenue Code by striking out "Secretary or his delegate" each place it appears and inserting in lieu thereof "Secretary". Paragraphs (B), (C), and (N) of subsection (b) (14) strike out "Secretary" and insert in lieu thereof "Secretary of the Treasury" in 26 provisions of the Code which currently use the term "Secretary" without reference to any of his delegates.

Subparagraphs (D), (I), (J), (L), and (M) of subsection (b) (14) change certain derivations of the term "Secretary or his delegate" (such as "Secretary nor his delegate") to "Secretary".

Subparagraphs (E), (F), and (H) of subsection (b) (14) change the term "Secretary" to "Secretary of Labor" in the following sections of the Code: 3304(c), 3310(d) (2), and 3310(e).

Subparagraph (G) of subsection (b) (14) amends sections 3221(a) and 3221(c) of the Code by striking out the words "of the Treasury" following the word "Secretary" so that the notification of certain actions by employers or by the Railroad Retirement Board required by such sections does not have to be made to the Secretary of the Treasury personally.

Subparagraph (K) of subsection (b) (4) substitutes "to the Secretary of the Treasury (or to such person as the Secretary of the Treasury" for "to the Secretary or to such person as the Secretary."

Chapter 80. General Rules

Sec. 1906(a) (60) (amends sec. 7803 of the Code)—other personnel

This paragraph is a clerical amendment redesignating subsection (d) as subsection (c), the previous subsection (c) having been repealed.

Sec. 1906(a) (61) (amends sec. 7809 of the Code)—deposit of collections

This amendment deletes cross references to provisions repealed by the Comprehensive Drug Abuse Prevention and Control Act of 1970.

Sec. 1906(b)—conforming and clerical amendments

This subsection of the bill makes clerical and conforming amendments to several sections and tables of sections of the Code to reflect the repeal of Code sections 6105, 6162, 6304, 6417, and 7641 and the amendment of Code sections 6111, 6154, 6416, 6420, 6424, 7448, 7508, 7509, and 7701 by section 1906(a) of this title.

Sec. 1906(c)—amendments to sections referring to Territories

This subsection amends sections 6871(a), 7622(b), and 7701(a)(4) of the Code by striking out references to Territories since there are no longer any United States Territories.

Sec. 1906(d)—effective date

Section 1906(d) provides that, except as otherwise expressly provided, the amendments made by section 1906 are to take effect on the first day of the first month which begins more than 90 days after the date of enactment of the bill, except that any amendment, when relating to a tax imposed by chapter 1 or chapter 2 of the Code is to apply with respect to taxable years beginning after December 31, 1976.

SEC. 1907. AMENDMENTS OF SUBTITLE G; THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Paragraph (1) of subsection (a) substitutes the name "Joint Committee on Taxation" for "Joint Committee on Internal Revenue Taxation" in section 8001. This change is made in the interest of brevity and does not change the functions of the Joint Committee. The duties of the Joint Committee are set forth in section 8022 of the Internal Revenue Code and relate only to internal revenue taxes and to the Internal Revenue Service (or any other agency to the extent it is charged with administration of those taxes).

Paragraph (2) amends section 8004 to refer to the compensation of "the Chief of Staff" instead of "a clerk," thus conforming this provision to the present language of section 8023(b).

Paragraph (3) of subsection (a) strikes out an outdated limitation on the cost of stenographic services incurred by the Joint Committee.

Paragraph (4) is a clerical amendment to make more readable section 8023(c), dealing with the inapplicability of reorganization plans to the Joint Committee.

Paragraph (5) is a general provision that all references in any other statute, or in any rule, regulation, or order to the Joint Committee on Internal Revenue Taxation are to be considered to be made to the Joint Committee on Taxation.

Subsection (b) provides conforming amendments for appropriate changes in references to the Joint Committee on Internal Revenue Taxation in sections 6103(d)(2) and 6405(a) of the Code. Subsection (b) also makes conforming amendments to the heading of subtitle G and to the table of subtitles.

Subsection (c) provides that the amendments made by this section of the bill are to take effect on the first day of the first month which begins more than 90 days after enactment.

PART II—AMENDMENTS OF CODE PROVISIONS WITH LIMITED CURRENT APPLICATION, REPEALS AND SAVINGS PROVISIONS

Sec. 1951. Provisions of subtitle A

Sec. 1951(a) (explanation of references to sections)

This subsection eliminates the need of repeated references to the Internal Revenue Code of 1954 in this section by providing that, when this section of the bill refers to an amendment or repeal of a section or other provision, that is to be considered an amendment or repeal of a section or other provision of the Internal Revenue Code.

Sec. 1951(b)(1) (amends sec. 72 of the Code)—certain joint and survivor annuities

Subparagraph (A) of this paragraph removes from the Code a special provision for joint and survivor annuities where the first annuitant died in 1951, 1952, or 1953. Subparagraph (B), however, provides that the deleted provision is to continue to apply in cases of annuity contracts under which distributions were made in taxable years beginning before January 1, 1977, and to which the deleted provision was applicable.

Sec. 1951(b)(2) (amends sec. 108 of the Code)—railroad corporations' discharge of indebtedness

This provision strikes out a special rule of very limited current applicability relating to an exclusion from the income of railroad corporations for income arising from the discharge, cancellation, or modification of indebtedness pursuant to a receivership proceeding or reorganization proceeding under section 77 of the Bankruptcy Act which was commenced before January 1, 1960. The special rule continues to apply, however, to any existing railroad corporation receivership or reorganization proceeding commenced before 1960.

Sec. 1951(b)(3) (amends sec. 164 of the Code)—payments for municipal-type services in Atomic Energy Communities

This paragraph strikes out a provision that authorizes deduction of certain amounts paid to the Atomic Energy Commission (or its successors, currently the Nuclear Regulatory Commission) for municipal-type services in atomic energy communities. However, the committee understands that payments are still being made for such services in Los Alamos, New Mexico. For this reason, the provision is to have continued application to amounts paid or accrued in a community in which the Commission's successor provided municipal-type services on December 31, 1976.

Sec. 1951(b)(4) (repeals sec. 168 of the Code)—60-month amortization of emergency facilities

This paragraph repeals the provision allowing five-year amortization of emergency facilities. The provision is largely obsolete since certification of an emergency facility is required if the rapid amortization is to be allowed, but the existing provision does not permit certification after 1959.

Some additional language in the bill's provision is necessitated by a conforming amendment to section 642(f) of the Code.

Sec. 1951(b)(5) (amends sec. 171 of the Code)—amortizable bond premium for certain bonds acquired after January 22, 1954, and before January 1, 1958

This provision strikes from the Code a special rule relating to the amortizable bond premium of taxable bonds (for which an election is made under section 171(c) of the Code) issued after January 22, 1951, with a call date not more than three years after the issue date, if acquired by the taxpayer after January 22, 1954, and before January 1, 1958.

Although stricken from the Code, this special rule is retained in the public laws for all such bonds.

Sec. 1951(b)(6) (amends sec. 333 of the Code)—liquidations of certain corporations affected by the Revenue Act of 1964

This paragraph deletes a provision allowing stockholders to elect the application of certain nonrecognition of gain rules in cases of liquidation distributions of corporations that were not personal holding companies in one of the two taxable years ending before February 26, 1964 (the date of enactment of the Revenue Act of 1964) but which would in that year have been personal holding companies under the new, stricter provisions of this Act.

Shareholders of such corporations may still claim the benefit of nonrecognition of gain rules applicable to liquidations after 1966 if their corporations meet certain tests and requirements set out in the existing section 333(g)(2). Therefore, the bill retains those particular provisions in the public laws, although they are deleted from the Code.

Sec. 1951(b)(7) (amends sec. 453 of the Code)—certain installment sales prior to 1954

This paragraph strikes from the Code references to the tax treatment of payments on installment sales of realty and casual installment sales of personalty concluded before 1954. The special rule applicable to those sales made before 1954 is retained in the public laws, however, for the continued use of taxpayers now eligible to use this rule because their sales were covered by section 44(b) of the Internal Revenue Code of 1939. (Before 1954, installment sales tax treatment for sales of this class could be obtained only if there was a payment or payments of a total not exceeding 30 percent of the selling price in the taxable year of the sale. After 1953, it was not required that there be any payment in the year of sale.)

Sec. 1951(b)(8) (amends sec. 512 of the Code)—exclusions from unrelated business taxable income

This paragraph deletes a provision of the Code (sec. 512(b)(13)) excluding from the definition of unrelated business taxable income certain income received by exempt trusts created by the wills of individuals who died between August 16, 1954, and January 1, 1957, if that income is received by those trusts as limited partners (as defined). Also deleted is an exclusion of income used by a labor, agricultural, or horticultural organization to establish, maintain, or operate a retirement home, hospital, or similar facility, if the income is derived from agricultural pursuits on grounds contiguous to the facility and if the income does not provide more than 75 percent of the cost of operating or maintaining the facility.

For both cases, a savings provision is retained in the public laws to continue to allow these exclusions.

Sec. 1951(b)(9) (amends sec. 545 of the Code)—deductions allowable in computing personal holding company income

This provision strikes from the Code a paragraph (sec. 545(b)(9)) which permits the deduction from personal holding company income (upon which a special 70-percent tax rate is imposed) of the amount of any properly filed lien in favor of the United States to which the taxpayer is subject at the end of the taxable year. This provision appears to have rare, if any, usage now. It was enacted in 1951 for the benefit of a personal holding company which is no longer in existence.

The paragraph to be deleted also requires the sum of the amounts deducted to be recaptured by their inclusion in the taxable income of the taxpayer for the year the lien is satisfied or released, and it permits the taxpayer's shareholders to compute the income tax on dividends attributable to amounts so included in income as though they were received ratably over the period the lien was in effect. These latter provisions are retained in the public laws for application to recaptures, on account of liens satisfied or released in taxable years beginning on or after January 1, 1977, of deductions taken in taxable years beginning before that date.

Sec. 1951(b)(10) (amends sec. 691 of the Code)—installment obligations received from a decedent

This paragraph deletes the provision allowing taxpayers to elect to report, on a pro rata basis, installment payments on certain obligations transferred from a decedent (in taxable years to which the 1939 Code applied) without the necessity of maintaining a bond with the Internal Revenue Service to guarantee the proper reporting of the installment payments, as had been necessary with respect to returns required to be filed before September 3, 1964.

It is believed either that none of these obligations are still outstanding, or, if any are, that the taxpayers have already exercised the election. This amendment preserves the rights of any taxpayers still reporting such installment payments who will have made the election with respect to taxable years beginning before January 1, 1977.

Sec. 1951(b)(11) (amends sec. 817 of the Code)—life insurance company gains on transactions occurring prior to January 1, 1959

This paragraph deletes from the Code section 817(d), which excludes from taxation gains realized by life insurance companies in cases of gains from, or considered under the life insurance company tax provisions as from, the sale or other disposition of a capital asset (or of property which, except for section 817(d), would constitute section 1231 assets) before 1959. Before 1959, such gains were usually not subject to tax in the case of life insurance companies.

It is unlikely that this provision has any current applicability since taxpayers are not likely to be currently receiving gains from pre-1959 dispositions, except in the limited area of installment sales. In those cases, the number of transactions to which the provision might apply may be expected to decrease each year. For these reasons, the provision is removed from the Code, but retained in the public laws.

Sec. 1951(b)(12) (repeals sec. 1347 of the Code)—claims filed against the United States before January 1, 1958

This paragraph deletes from the Code a provision limiting to 33 percent of the amount paid (without taking into account the interest paid), the tax payable on payments by the United States on claims unpaid for 15 years and involving the acquisition of property. The provision applied only if the claim was filed before January 1, 1958.

It is believed that no claim of the type described in section 1347 is still outstanding. If any does exist, however, it will remain subject to the same tax treatment by virtue of the inclusion in the public laws of the provision deleted from the Code.

Several conforming changes necessitated by the deletion of section 1347 are also made.

Sec. 1951(b)(13) (repeals sec. 1471 of the Code)—recovery of excessive profits on Government contracts subject to the Vinson-Trammel Act

This paragraph deletes from the Code a provision relating to a few possible situations of excessive profits on Government contracts not covered by the Renegotiation Act. In addition, the provision would be fully operative if the Renegotiation Act should ever be allowed to expire. Since this provision does not involve taxation as such, but instead provides for collection of certain excessive profits as taxes are collected, it is removed from the Code but retained in the public laws.

Sec. 1951(b)(14) (amends sec. 1481 of the Code)—renegotiated excessive defense contract profits of taxable years governed by the Internal Revenue Code of 1939

This paragraph deletes from the Code a provision (section 1481(d)) regarding the readjustment of taxes for taxable years governed by the Internal Revenue Code of 1939 if excessive defense contract profits taxed in those years are recaptured by the Government pursuant to the Renegotiation Act of 1951, as amended.

It is believed that no years governed by the Internal Revenue Code of 1939 (in general, taxable years beginning before January 1, 1954) are now in court or in the renegotiation process. However, it appears that some excessive profits renegotiated for years subject to the 1939 Code are still being collected. In addition, defense contractors and subcontractors who failed to file reports of renegotiatble profits for those years could be required to file such reports (although this is considered an unlikely possibility). For these reasons, the provision deleted from the Code is retained in the public laws.

Sec. 1951(c)—conforming and clerical amendments

This subsection provides conforming and clerical amendments necessitated by the repeals made by section 1951(b) of this title.

Sec. 1951(d)—effective date

Subsection (d) provides that the amendments made by section 1951 (b) and (c) of this title, except as otherwise expressly provided, are to apply to taxable years beginning after December 31, 1976.

SEC. 1952. PROVISIONS OF SUBCHAPTER D OF CHAPTER 39; COTTON FUTURES

This section repeals provisions (sections 4851 through 4877 of the Code) taxing cotton futures contracts. These provisions impose prohibitory taxes upon cotton futures contracts which do not meet the requirements set forth in these provisions and in related Department of Agriculture regulations. No tax is collected under these provisions, which provide the necessary authority to regulate the cotton futures market. (See legislative findings in title 7 of the United States Code at section 5, 6a (first sentence), and 2101 (second and third sentences).) The bill reenacts these provisions (providing appropriate penalties), which results in transferring the law on this subject out of the Internal Revenue Code. The material in this section has been reviewed by the Department of Agriculture, the New York Cotton Exchange, and the staff of the Committee on Agriculture of the House of Representatives.

A number of conforming and clerical amendments to the Code are necessitated by the repeal of sections 4851 through 4877 and are made by subsection (n). The provisions of this section of the title are to take effect on the 90th day after the date of enactment.

T. ENERGY—RELATED PROVISIONS

1. Residential Insulation Credit (sec. 2001 of the bill and new sec. 44A of the Code)

Present law

Under present law, no special credit or deduction is allowed for expenditures for insulation of a taxpayer's own residence.[1]

Reasons for change

A substantial portion of our domestic energy consumption is used to heat or cool residences. Currently, about 20 percent of our domestic consumption, or about 6 percent of total world demand, is used in the United States for residential purposes.

Because of the substantial energy savings that may be effected by proper insulation of homes, and to reduce the potential problems in the event of any future energy shortages (such as the 1973–74 shortage as the result of the oil embargo) the committee's amendment includes a refundable tax credit to give homeowners and tenants an incentive to conserve energy by immediate installations of insulation to reduce heat loss in the winter and to reduce heat gain in the summer. It is estimated that this tax credit will save between 50,000 and 100,000 barrels of oil per day by 1979.

Explanation of provision.

The committee's amendment provides a temporary program (through 1978) of credits against income tax for a portion of the expenditures incurred in that period for purchasing and installing insulation on homes. Under the amendment, a refundable credit against income tax is allowed for 30 percent of the first $750 (for a maximum credit of $225) spent on insulating a residence [2] used by the individual paying for the insulation. The credit being provided here is intended only as a temporary program in the sense that your committee wants to review it to see whether, in its view, the credit should be further extended. For that reason the amendment makes the credit available only for installations of insulation material before January 1, 1979, and only where payments were made (or, in the case of an accrual basis taxpayer, incurred) for the material before that date. Also, the amendment makes the credit available only for insulation of structures in use or habitable as residences on May 25, 1976, and only for insulation material installed and paid for on or after July 1, 1976. The credit is for both the expenditures for the insulation material itself and the expenditures for its installation.

[1] However, if the expenditures are undertaken in connection with the sale of the residence, then it has been held that those expenditures might be deductible under section 212 of the Code as being incurred in connection wth the production of income. Also, if the insulation is of such a magnitude as to be an improvement in the house, then the expenditures may constitute additions to the taxpayer's basis in the house.

[2] Condominium and cooperative housing units may be treated as separate residences.

The credit may be claimed only for insulation payments made during the year (or other tax period) for which the tax return is filed. To the extent that (during the period for which the credit is in effect) the taxpayer, in any prior year, has paid for insulation on that residence for which the credit was allowed—the $750 limit on the insulation expenditures for which the credit is given must be reduced by the amount of the earlier payments.[3]

If an individual has already claimed the maximum credit under the limitation for insulation installed on one residence and thereafter changes his residence, the limitation begins to run again from zero; that is, he may claim 30 percent of the first $750 spent on insulating his new residence. Since the credit is only for insulation of a residence, it is not available to a builder who does not plan to use the structure as his residence.

The insulation for which the credit may be claimed includes storm or thermal windows, storm doors, and similar items (such as weatherstripping, caulking, etc.) In addition, the committee amendment provides that clock thermostats are eligible items for the credit. However, the insulation qualifies only if it is specifically and primarily designed to reduce the heat loss or gain on a building, is material first used by the taxpayer claiming the credit, has a useful life (to that taxpayer) of at least 3 years, and meets those performance standards that may be prescribed in Treasury regulations. The Secretary of the Treasury is to consult with the Administrator of the Federal Energy Administration and the Secretary of Housing and Urban Development in developing those standards. (In conjunction with this last criterion, it is understood that the National Bureau of Standards, which is already engaged in performance studies regarding insulation materials, will be consulted for its expertise on technical questions concerning the properties of materials.)

In addition, the credit is to be allowed only for the original installation of insulation in a dwelling unit. As a result, expenditures for such purposes as the reinstallation in the fall of storm windows which had been taken down in the spring are not to qualify for the credit. Insulation removed from one structure and placed on the taxpayer's residence also will not qualify for the credit because of this requirement.

The Treasury Department is to prescribe methods by which taxpayers are to provide verification of their expenditures for qualified insulation. No credit is to be allowed for expenditures that are not verified in the prescribed manner.[4]

Qualifying insulation materials must be specifically and primarily designed for insulation use. Except with reference to storm or thermal windows or doors, the items that qualify for the credit are intended to be primarily and specifically insulating materials and not materials that are primarily structural or decorative in purpose. For example, drapes and wood paneling would not qualify although they may have been designed in part to have an insulating effect. Whether

[3] Note that expenditures before July 1, 1976, and installations before that date are not to qualify for the credit. Consequently, such pre-July 1, 1976, expenditures and installations are to be ignored in determining whether and to what extent the $750 limit is to be reduced under this provision.

[4] This provision is not to detract from the general authority of the Internal Revenue Service to require verification of the correctness of claimed deductions, credits, etc.; the effect of this provision is to preclude the use of the so-called "Cohan rule" where the Treasury regulations specifically prescribe one or more appropriate manners of vertification.

or not other materials such as attic fans, insulated siding, etc., qualify is left to administrative determination, which should take into account the extent of the energy saving, the extent of their use of conventional energy sources, and whether they otherwise meet the standards of this provision. In addition, since the credit is only for insulation installed in existing houses, and not for newly built homes or reconstructions, the replacement of an existing wall with a new wall having greater insulating qualities is not to qualify for the credit. Nevertheless, the replacement of an existing window or door by a storm or thermal door or window, or thermal window, could qualify although these items might otherwise be considered structural in nature.

The credit is available for materials that either reduce heat gain or reduce heat loss, as well as for materials that possess both these qualities. For example, polyester film installed on windows that has a cooling quality and which fulfills the requirements of the bill common to all qualifying materials would be eligible for the credit although it may possess no quality of reducing heat loss. However, the credit would not be available for polyethylene film (usually taped over a window) which does not normally have a useful life of at least 3 years.

If joint occupants of a dwelling unit install qualifying insulation in that dwelling unit during a calendar year, the total credit is subject to the regular limit for one person (30 percent of the first $750 of expenditures) and is apportioned among those who made the expenditures in accordance with the proportion which each paid bears to the total payment during the calendar year.

In the case of qualifying expenditures by a cooperative housing corporation, each of the corporation's stockholders who is entitled to occupy a dwelling unit owned by the corporation, and who in fact occupies the dwelling unit as his residence, is treated as having paid for that portion of the corporation's qualifying expenditures that is the same as his proportionate share of the corporation's total outstanding stock.

The expenditures made by a residence's owner that qualify for the credit in some instances may constitute capital expenditures that under present law increase his tax basis in the residence. In order to avoid a double tax benefit (allowance on a credit and also a reduced gain on sale), the committee amendment requires that any increase in basis on account of a qualified insulation expenditure be reduced by the amount of the expenditure that is allowed as a credit. For example, assume that the taxpayer makes $800 of qualified expenditures which would normally increase his basis in the home. The maximum credit allowable in this case is $225 (30 percent of the $750 limit). Consequently, the taxpayer's basis in his home would be increased by $575 (the $800 of expenditures minus the $225 of credit).

Under the committee amendment, the home insulation credit is a refundable credit (that is, a taxpayer whose tax liability is less than the amount of the credit would receive a refund of the difference, while the amount of his credit that equals the amount of his tax liability would be available to eliminate that liability).

The House bill contained no comparable provision. However, the House energy tax bill (H.R. 6860) would provide a similar credit, except that: (1) the maximum expenditures taken into account would be $500, (2) the $500 would be reduced by prior owners' and renters' insulation expenditures for the residence, (3) the credit would not be refundable, but instead could be used only to reduce or eliminate income tax liability, (4) the credit would be available for the period March 15, 1975, through December 31, 1977, (5) the credit would be only for principal residences, and (6) all allowable expenditures (not only those claimed and allowed) would count toward the maximum expenditure limit.

Effective date

This credit is to be available only if both expenditures (or accurals) for insulation and the installation of that insulation is made on or after July 1, 1976, and before January 1, 1979, on a structure existing in May 25, 1976. However, expenditures on binding contracts entered into before January 1, 1979, may also qualify.

Before the insulation credit program expires at the end of 1978, the committee intends to again examine the usefulness of this tax incentive approach and the availability of other approaches to secure the necessary energy savings.

Revenue effect

This provision will reduce budget receipts by $192 million in fiscal year 1977 and $320 million in fiscal year 1978.

2. Residential Solar or Geothermal Energy Equipment Credit (sec. 2002 of the bill and new sec. 44B of the Code)

Present law

Under present law, no special tax credit or deduction is allowed for solar energy equipment or for geothermal energy equipment installed for a residence.[1]

Reasons for change

As indicated above in the discussion on a tax credit for installing home insulation, residential energy is a major portion of the total energy consumption. In view of the general energy conservation needs of the country in the years ahead, the committee believes that it is appropriate to encourage residential installations of solar or geothermal energy equipment.

The solar and geothermal equipment and insulation industries represent a major area of possible future fossil fuel conservation and should, over a period of time, substantially aid in meeting the problem of decreasing fossil fuels. At the same time, it must be acknowledged that the solar and geothermal equipment industries are still fledgling industries. In view of this, the committee believes that there is a need to encourage these industries through tax incentives. The committee believes that tax credits provided by its amendment will help achieve this without significant revenue loss for the next several years.

As a result, the committee decided to provide a credit for a limited number of years with the intent to review the need for the credit

[1] However, if the expenditures are undertaken in connection with the sale of the residence. then those expenditures might be deductible under section 212 of the Code as incurred in connection with the production of income. Also. if installations constitute improvements to a residence. the expeditures may qualify as additions to the taxpayer's basis in the residence for purposes of determining gain.

toward the end of that period when more facts will be available as to the extent of the possible expansion in the use of these types of equipment.

Explanation of provision

The committee amendment provides a refundable income tax credit for solar and geothermal energy equipment installed in, on, or in connection with a residence. The credit is 40 percent of the first $1,000 of qualified expenditures, plus 25 percent of the next $6,400 (maximum credit of $2,000). To qualify, both the equipment and its installation must be paid for by the individual (or individuals) who is using the edifice as a residence. Thus, an owner or tenant might qualify, but a developer or builder adding the solar energy equipment to a new house he does not intend to use as his residence would not qualify for this credit, although he might qualify for the investment tax credit extended under this amendment to solar energy equipment installed for commercial or industrial purposes.

For purposes of the dollar limitations on the amount of expenditures that may be taken into account in determining the credit, expenditures for solar equipment and installation and expenditures for geothermal equipment and installation are aggregated. In other words, a taxpayer who had already made purchases of $7,400 for solar equipment allowed during the credit period could not make qualifying expenditures for geothermal equipment for the benefit of the same residence.

This tax credit is to be provided only for installations and expenditures made, or, in the case of an accrual basis taxpayer, incurred, through 1980. Before that time, the committee will review the credit to see whether it is desirable to continue it for any further period of time. Also, both the installation and the expenditure must occur after June 30, 1976. The credit is for both the expenditures for the eouipment itself and the expenditures for its installation.

Unlike the case of the credit for installation of insulation on an existing residence, solar and geothermal energy installation expenditures on both existing residences and newly-constructed residences[2] qualify for the credit.

The credit may be claimed only for qualified payments made during the year or other tax period for which the tax return is filed. To the extent that (during the period for which the credit is in effect) the taxpayer during any prior year paid for solar energy installations on that residence which qualified for the credit, the dollar limitations on the solar or geothermal energy expenditures for which the credit is given must be reduced by the amount of the earlier qualified payments.[3]

If an individual who has already claimed the maximum credit under the dollar limitations for solar or geothermal energy equipment installed on one residence. or who has partially used his limitations, thereafter changes his residence, the limitations begin again to run from zero, and he may claim 40 percent of the first $1,000 paid, and 25 percent of the subsequent qualifying expenditures for equipment installed on his new residence.

[2] Condominium and cooperative units may be treated as separate residences.

[3] Note that expenditures before July 1. 1976. and installations before that date are not to qualify for the credit. Consequently, such pre-July 1, 1976. expenditures and installations are to be ignored in determining whether and to what extent the expenditure limit is reached under this provision.

The equipment for which the credit may be claimed is that which uses solar or geothermal energy to heat or cool a building or to provide hot water for it and, in the case of solar equipment, which meets the definitive performance criteria prescribed by the Secretary of Housing and Urban Development under the Solar Heating and Cooling Demonstration Act of 1974. In the case of geothermal equipment, it must be equipment which is necessary to distribute or use geothermal steam and associated geothermal resources (as defined in sec. 2(c) of the Geothermal Steam Act of 1970—30 U.S.C. 1001(c)).

It is usually necessary, at least at this stage of the solar energy equipment industry's technical advancement, to use heating or cooling units employing conventional energy sources as "back-ups" to solar energy equipment for use or supplemental use when very little sunlight has been available for an extended period of time. However, the credit of this provision is not to extend to expenditures for these back-up units.

If joint owners install qualifying solar or geothermal energy equipment on their common residence, the credit is to be apportioned among those who paid for the installations in accordance with the proportion which each paid bears to the total payment during the calendar year.

In the case of qualifying expenditures by a cooperative housing corporation, each of the corporation's stockholders who is entitled to occupy a dwelling unit owned by the corporation, and who in fact occupies the dwelling unit as his residence, is treated as the resident in that unit and as having paid for that portion of the corporation's qualifying expenditures that is the same as his proportionate share of the corporation's total outstanding stock. Similarly, in the case of duplex, triplex, etc., houses, the expenditure for solar or geothermal energy may be shared between the respective residents.

Expenditures made by a resident that qualify for the credit would normally constitute capital expenditures that increase the tax basis of the residence. In order to avoid a double tax benefit (allowance of a credit and also a reduced gain on sale) the committee amendment requires that any increase in basis on account of a qualified solar or geothermal energy expenditure be reduced by the amount of the expenditure that is allowed as a credit. For example, assume that the taxpayer makes $2,500 of qualified expenditures which would normally increase his basis in the home. The maximum credit allowable in this case is $775 (40 percent of the first $1,000 plus 25 percent of the next $1,500). Consequently, the taxpayer's basis in his home would be increased by $1,725 (the $2,500 of expenditures minus the $775 of credit).

The solar and geothermal energy credits are refundable credits. As a result, a taxpayer whose tax liability is less than the amount of the credit would receive a refund of the difference, while the amount of his credit that equals the amount of his tax liability would be available to eliminate that liability.

The House bill contained no comparable provision. However, the House-passed energy tax bill (H.R. 6860) provided a similar credit except that: (1) the credit would be 25 percent of the first $8,000 (a maximum credit of $2,000); (2) the credit would not be refundable; (3) expenditures for geothermal energy equipment and its installation would not be eligible for the credit; (4) the credit would be available only to owners of the principal residences in question; (5) the qualifying expenditures of prior owners of the principal residence in question would be taken into account in determining whether the dollar limitations (25 percent of the first $8,000 under the House bill) had not been exceeded; (6) all allowable expenditures (not only those claimed and allowed) would count toward the maximum expenditure limit; and (7) it contained no building contract rule.

Effective date

The committee amendment would make the credit available in cases in which both the expenditure and the installation of the qualifying equipment occurred on or after July 1, 1976, and before January 1, 1981. Before the credit period expires as of December 31, 1980, the committee intends to reexamine the usefulness of this credit approach and the availability of other approaches to secure the necessary energy savings.

Revenue effect

It is estimated that the credits for solar and geothermal energy equipment and its installation will result in a negligible revenue loss through the fiscal year 1978 and a loss of $31 million in fiscal year 1981.

3. Residential Heat Pump Credit (sec. 2002 of the amendment and new sec. 44B of the Code)

Present law

Under present law, no special tax credit or deduction is allowed for installing a heat pump in a residence.[1]

Reasons for change

The heat pump's facility of transferring heat from outside air to indoor premises can reduce the resident's electricity bill by 30 to 50 percent, according to some estimates. This effect results from the lesser amount of electrical energy needed to power the heat pump as compared with the electricity required by traditional electric heating equipment.

Because of this saving in electrical energy consumed where heat pumps are used, the committee believes it is desirable to encourage the use of heat pumps. Therefore, the committee amendment includes a credit designed to make installations of heat pumps more attractive. As is the case with the other energy-related credits provided by the committee amendment, it is believed that the expanded use of heat pumps will alleviate future energy crises and result in the conservation of fossil fuels.[2]

Since the use of heat pumps is in a more advanced technological stage than is the use of solar and geothermal equipment, the committee is making the credit for installation of heat pumps available for a

[1] However, if the expenditures are undertaken in connection with the sale of the residence, then those expenditures might be deductible under section 212 of the Code as incurred in connection with the production of income. Also, if installations constitute improvements to a residence, the expenditures may qualify as additions to the taxpayer's basis in the residence for purposes of determining gain.

[2] Of course, to the extent the generators supplying electricity to heat pumps use nonfossil fuels in converting energy to electricity, an even greater conservation of fossil fuels will result.

shorter period of time than is the case of the credits for solar and geothermal energy equipment also provided by this committee amendment.

Explanation of provision

The committee amendment provides a refundable income tax credit for the installation of heat pumps in, on, or in connection with any residential use by the taxpayer. The amount of the credit is half of the percentage amount of the credit provided in the committee amendment for solar and geothermal energy equipment. The amount of the credit for installation of a heat pump is, therefore, 20 percent of the first $1,000 of qualified expenditures, plus 12½ percent of the next $6,400 (maximum credit of $1,000). To qualify, the expenses must be paid by the individual (or individuals) who is using the structure as a residence. Thus, an owner or tenant may qualify, but a developer or builder adding the heat pump equipment to a new house he does not intend to use as his residence would not qualify for this credit. Expenditures that are taken into account in determining the credit expenditures for solar and geothermal equipment are aggregated with the expenses for a heat pump in determining the amount of the credit and in applying the limitations. In other words, a taxpayer who has made purchases of $7,400 within the applicable period, which were allowed for purposes of the credit for solar and/or geothermal energy equipment, could not utilize the credit available for expenditures for heat pump equipment for the benefit of the same residence.[3]

The credit is for both the expenditures for the equipment itself and the expenditures for its installation. Expenditures for presently existing structures, but not for houses built during the credit period, will qualify for the credit.

The credit may be claimed only for qualified payments during the year or other tax period for which the tax return is filed.[4]

If any individual who has already claimed the maximum credit under the dollar limitations for solar, geothermal, or heat pump equipment installed on one residence, or who has partially used his limitation, thereafter installs a heat pump on another residence, the limitations begin again to run from zero, and he may claim 20 percent of the first $1,000 paid, and 12½ percent of the subsequent $6,400 of qualifying expenditures.

The equipment for which the credit may be claimed is that necessary to permit a heat pump to function in a home. This would include any special ducting required. "Function" in this sense refers to the capacity of a heat pump to heat or cool a building, to provide hot water for it, or to perform any of the other uses normal to the heat pump under the circumstances.

It is usually necessary, at least at this stage of the heat pump industry's technical advancement, to use heating or cooling units employing conventional energy sources as "back-ups" to the heat pump for use or supplemental use during periods when the outdoor temperature falls below approximately 25 degrees Fahrenheit. However, the credit is not to be available for expenditures for these back-up units.

[3] Condominium and cooperative units are treated as separate residences.

[4] Pre-July 1, 1976, expenditures and installations are to be ignored in determining whether and to what extent the expenditures limit is reached under this provision.

If joint owners install a heat pump for their common residence, the credit is to be apportioned among those who paid for the installations in accordance with the proportion which each paid bears to the total payment during the calendar year.

In the case of qualifying expenditures by a cooperative housing corporation, each of the corporation's stockholders who is entitled to occupy a dwelling unit owned by the corporation, and who in fact occupies the dwelling unit as his residence, is treated as the resident in that unit and as having paid for that portion of the corporation's qualifying expenditures that is the same as his proportionate share of the corporation's outstanding stock. Similarly, in the case of duplex, triplex, etc., houses, the expenditures for a heat pump may be shared by the respective residents.

Expenditures made by a resident that qualify for the credit would normally constitute capital expenditures that increase the tax basis of the residence. In order to avoid a double tax benefit (allowance of a credit and also a reduced gain on sale of the residence), the committee amendment requires that any increase in basis on account of a qualified heat pump expenditure be reduced by the amount of the expenditure that is allowed as a credit. For example, assume that the taxpayer makes $2,500 of qualified expenditures which would normally increase his basis in the home. The maximum credit allowable in this case is $372.50 (20 percent of the first $1,000 plus 12½ percent of the next $1,500). Consequently, the taxpayer's basis in his residence would be increased by $2,127.50 (the $2,500 of expenditures minus the $372.50 credit).

The heat pump credit is a refundable credit. As a result, a taxpayer whose tax liability is less than the amount of the credit would receive a refund of the difference, while the amount of his credit that equals the amount of his tax liability would be available to eliminate that liability.

Neither the current House bill nor the House-passed energy tax bill provided a tax credit, or any tax incentive, for installation of a heat pump.

Effective date

This credit is to be available only for expenditures (or, in the case of an accrual basis taxpayer, incurred) for qualifying equipment and installations which occur after June 30, 1976, and before January 1, 1979, except in the case of a binding contract entered into before that date. The installations themselves must also be made during that same period. In addition, if the expenditure is to qualify, the heat pump must be installed on a dwelling unit located in the United States which is occupied or habitable on May 25, 1976. Upon expiration of the credit period, the committee intends to reexamine the usefulness of this credit approach and the availability of other approaches to secure the necessary energy savings.

Revenue effect

It is estimated that the credit for heat pumps and their installation will reduce revenues by $3 million in fiscal 1977, $5 million in fiscal 1978, and $6 million in fiscal 1979.

4. Business Insulation Credit (sec. 2003 of the bill and sec. 46A of the Code)

Present law

Under present law, property eligible for the investment tax credit does not generally include buildings or their structural components (sec. 48(a)(1)(B)). Structural components which are excluded from the credit include such parts of a building as walls, ceilings, paneling for walls, electrical systems and plumbing systems. Similarly, other parts of a building which relate to the operation of the building as a whole or are of an inherently permanent nature are considered structural components and do not qualify for the investment credit.[1]

Reasons for change

The committee believes an important factor in reducing consumption of our energy resources is to encourage measures which result in the more efficient use of these resources. Studies have shown that the efficiency of heating and cooling systems in buildings is significantly increased (and energy consumption is reduced) where adequate insulation is used. As in the case of residences, the committee has concluded that the installation of insulation in business properties is an appropriate energy-saving measure which should be encouraged and has made the 10-percent investment credit available for insulation and certain other energy-saving building components installed in business properties.

Explanation of provision

This provision expands the types of property eligible for the investment credit to include insulation and other energy-saving components which are installed in existing buildings and structures used in a trade or business or for the production of income. The credit is available for both the costs of the insulation material and its installation. Except for a change in its effective period, this committee amendment is the same as the provision in the House-passed energy tax bill (H.R. 6860).

In order to qualify for the investment credit under this provision, insulation must be installed after December 31, 1976, and before January 1, 1979. Similarly, the taxpayer's costs for the insulation must have been paid or have been properly accruable under the taxpayer's method of accounting after December 31, 1976, and before January 1, 1979. In addition, the insulation must be installed in a building or other structure which was, on January 1, 1977, being used for business purposes or for the production of income. However, it is not necessary that the business use of the building (in which the insulation is installed) occur in the hands of the taxpayer claiming the credit for this purpose. For example, a taxpaver may claim the credit on his costs for insulation installed in a building he acquires after December 31, 1976, where the building was used for business purposes both on that date and on the date of the installation by the taxpayer.

In the case of leased buildings, the credit is available to either the owner or the tenant who installs insulation in the building, regardless of any lease terms or provisions of local law under which title to property attached to a leased building passes to the owner of the building.

[1] Rev. Rul. 75-78, 1975-10 I.R.B. 7; Rev. Rul. 70-103, 1970-1 Cum. Bull. 6.

However, it is available only to the one of these parties upon whom lies the ultimate burden for the cost of the insulation. For example, if the tenant installs insulation in a leased business structure at his own expense and without any direct or indirect remuneration by the owner, the tenant is entitled to the investment credit for the costs of the insulation. However, if the tenant recovers these costs from the owner, either directly or through a reduction in rental payments, the owner is entitled to the investment credit. In this latter situation, the owner is considered to have paid or incurred his costs when repayment is made to the tenant either directly or through a reduction in the rental payments.

Insulation does not qualify for the investment credit where it is installed as part of a reconstruction of the building. For these purposes, the term "reconstruction" is intended to mean a major reconditioning or renovation of the building.

The investment credit is also made available for insulation installed in business properties which are used predominantly to furnish lodging. As a result, the credit under the provision is available for insulation installed in hotels or motels used to provide accommodations for transients as well as for insulation installed in rental properties, such as apartments, which are leased for periods in excess of 30 days.

The insulation for which the credit may be claimed includes storm or thermal windows, storm doors, and similar items (such as weatherstripping or caulking, etc.) In addition, the committee amendment includes clock thermostats as an item eligible for the credit. However, the insulation qualifies only if it is specifically and primarily designed to reduce the heat loss or gain on a building, is material first used by the taxpayer claiming the credit, has a useful life (in the hands of the taxpayer) of at least three years, and meets performance standards to be set by the Secretary of the Treasury or his delegate after consultation with the Administrator of the Federal Energy Administration and the Secretary of Housing and Urban Development. (In conjunction with this last criteria, it is understood that the National Bureau of Standards, which is already engaged on performance studies regarding insulation materials, will be consulted for its expertise on technical questions concerning the properties of materials.)

In addition, the credit is to be allowed only for the original installation of insulation in a business building or structure. As a result, the replacement of, for example, a storm window with another storm window of substantially similar insulating quality does not qualify for the credit. Insulation removed from one business structure and placed on another business structure also will not qualify for the credit because of this requirement.

The Secretary of the Treasury or his delegate is to prescribe methods by which expenditures for qualified insulation are to be verified by taxpayers.

Qualifying insulation materials must be specifically and primarily designed for insulation use. Except with reference to storm windows or doors and thermal windows, the items that qualify for the credit are intended to be primarily and specifically insulating materials, and not materials that are generally considered to be structural or decorative in purpose. For example, draperies and wood paneling would not qualify although they may have been designed to have an insulating effect. Whether or not other materials, such as ventilating fans and clock thermostats, etc., qualify is left to administrative determination which should take into account the extent of the energy saving, the extent of their use of conventional energy sources and whether they otherwise meet the standards of this provision. In addition, since the credit is only for insulation installed on existing buildings, and not for new or reconstructed buildings, substantial structural improvements or replacements, such as the replacement of an existing wall with a new wall having greater insulating qualities, would not qualify for the credit. Nevertheless, since the committee expressly named storm windows or doors and thermal windows as qualifying for the credit, the replacement of an existing window or door by a storm door or window, or thermal window, could qualify although these items might be considered structural in nature.

The credit is available for materials that either reduce heat gain or reduce heat loss, as well as for materials that possess both these qualities. For example, polyester film installed on windows that has a cooling quality and which fulfills the requirements of the bill common to all qualifying materials would be eligible for the credit although it may possess no quality of reducing heat loss. On the other hand, polyethylene film would normally not qualify because it does not usually have a useful life of at least three years.

Effective date

The changes made by this provision of the committee amendment are to apply to installations of insulating components in qualifying buildings after December 31, 1976, and before January 1, 1979, where the costs of these components are also paid or accruable during this period.

Revenue effect

It is estimated that this provision will reduce business tax liabilities by $11 million for fiscal 1977, $26 million for fiscal 1978, and by $15 million for fiscal 1979.

5. Business Solar and Geothermal Equipment Credit (sec. 2003 of the bill and new sec. 46A of the Code)

Present law

Under present law, property which is attached to or becomes a structural component of a building does not generally qualify for the investment credit. To the extent solar or geothermal energy equipment constitutes a structural component of a building, therefore, it does not qualify for the investment credit.

Reasons for change

As indicated previously, the committee believes that it is important to encourage the development of new sources of energy. Primary sources of new energy are expected to be those obtained from the capture of heat directly from the sun or from the earth. The amendment made by the committee already takes this into account in providing solar and geothermal equipment credits for use of these sources of energy in a residence. It is probably still more important, however, to also encourage the use of these new forms of energy by industrial and commercial users, which account for approximately 55 percent of the nation's energy consumption.

As indicated in connection with the residential credit, both the solar energy and geothermal industries provide an important way of conserving fossil fuel and mitigating fossil fuel energy shortages. Since these industries are in their first stages of development, the committee believes a tax credit is needed to encourage interest in the use of these forms of energy at a more rapid pace than could otherwise be expected.

Explanation of provision

The committee amendment extends the investment credit to solar or geothermal energy equipment installed for use in a trade or business or as part of a facility held for the production of income. The amount of the credit is to be 20 percent of the qualified solar or geothermal energy equipment installation investment beginning January 1, 1977, through 1981. After that time the credit is reduced to 10 percent for this type investment through 1986. Both the 20-percent and the 10-percent credits apply to the costs for the solar or geothermal energy equipment itself and also to costs of installation.

The credit is to be applicable whether or not the equipment would otherwise fail to qualify because it is a structural component of a building. Furthermore, it is to be applicable even if the equipment is property used for lodging that would otherwise fail to qualify for the investment credit (under sec. 48(a) (3) of the Code).

In the case of leased buildings, the credit is available to either the owner or the tenant who installs solar or geothermal energy equipment in conjunction with the building, regardless of any lease terms or provisions of local law under which title to property attached to a leased building passes to the owner of the building. However, it is available only to the one of these parties upon whom lies the ultimate burden for the cost of the equipment. For example, if the tenant installs equipment in a leased business structure at his own expense and without any direct or indirect remuneration by the owner, the tenant is entitled to the investment credit for the costs of the equipment. However, if the tenant recovers these costs from the owner, either directly or through a reduction in rental payments, the owner is entitled to the investment credit. In this latter situation, the owner is considered to have paid or incurred his costs when repayment is made to the tenant either directly or through a reduction in the rental payments.

The investment credit is also made available for solar or geothermal enenrgy equipment installed in business properties which are used predominantly to furnish lodging. As a result, the credit under this provision is available for solar or geothermal energy equipment installed in rental properties, such as apartments, which are leased for periods in excess of 30 days, as well as for equipment installed in hotels or motels used to provide accommodations for transients.

The solar or geothermal energy equipment for which the credit may be claimed is that which uses solar or geothermal energy to heat or cool a building or to provide hot water for it. In addition, in the case of solar energy equipment, it must meet the definition performance criteria prescribed by the Secretary of Housing and Urban Development under the Solar Heating and Cooling Demonstration Act of 1974. Geothermal equipment is property which is necessary to distribute or use geothermal steam and associated geothermal resources as defined in section 2(c) of the Geothermal Steam Act of 1970 (30 U.S.C. 1001 (c)). Furthermore, in both cases, the original use of the equipment must originate with the taxpayer.

This investment tax credit covers equipment such as heat exchangers and special ducting. Geothermal energy is not to be restricted to any particular type of fluid or gas extracted from a geothermal resource.

It is usually necessary, at least at this stage of the industry's technical advancement, to use heating or cooling units employing conventional energy sources as "back-ups" to solar energy equipment for use or supplemental use when very little sunlight has been available for an extended period of time. The credit in this provision is not to extend to expenditures for these back-up units.

The credit is only available for solar energy equipment that utilizes solar energy to heat or cool a building or structure in the conventional direct manner. It is not available, for example, to a system that employs solar energy to produce wind for the creation of electricity through the medium of windmills.

The current House bill contains no similar provisions. However, the House energy tax bill (H.R. 6860) provides a similar credit for solar energy except that: (1) the credit would be available only for equipment purchased and installed after March 17, 1975, and before January 1, 1981; (2) the credit would be at the then current investment credit rate.

Effective date

To qualify for the 20-percent credit, the solar energy equipment must be installed after December 31, 1976, and before January 1, 1982; and the costs for the equipment must also have been paid or be properly accruable (under the taxpayer's method of accounting) after December 31, 1976, and before January 1, 1982. Similarly, to qualify for the reduced 10-percent credit allowance applicable after 1981, the equipment must be installed after December 31, 1981, and before January 1, 1987. The costs for this equipment eligible for the 10-percent credit must have been paid or be properly accruable after December 31, 1981, and before January 1, 1987. In the case of both the pre-1982 property and the pre-1987 property, however, installations of equipment after those periods may qualify for the investment credit of 20 percent and 10 percent, respectively, in certain cases of binding contracts entered into before those years, under circumstances described in section 49 of the Code.

Revenue effect

The revenue loss under this provision is expected to be negligible.

6. 12-Percent Investment Tax Credit and Other Changes Relating to Energy Conservation and Production Property (sec. 2003 of the bill and sec. 46A of the Code)

Present law

Under present law, a 10-percent investment credit is permitted for the capital costs of several different types of special-purpose business machinery, equipment and facilities. However, in general, no investment credit is allowed for a building and its structural components (sec. 48(a)(1)(B)).

Reasons for change

The committee concluded that our energy goals can better be met and our supply of available energy can be increased by providing an investment credit for certain types of energy-related investment, and by increasing the investment credit for other types of energy-saving equipment to which the investment credit of existing law is already extended.

Energy saving can be achieved through the increased use of insulation; however, the present investment credit is not normally available for purchases of insulation because insulation has been considered a structural component of a building. It is the intent of the committee to stimulate energy conservation in commercial, industrial and residential activity by extending the investment credit to insulation, as well as to other energy-related investment such as solar or geothermal and structural components. (The investment credit provisions relating to insulation and solar and geothermal property are discussed above.)

The commercial production of oil from shale rock and the gasification or liquefaction of coal are areas where our energy resources will be substantially enhanced, when commercially viable production can begin. For the same reasons, investment in pipelines for transporting coal slurry, equipment to permit the use of waste as a fuel and to process waste into fuel, and equipment to recycle and to sort and prepare solid waste for recycling should be encouraged.

Equipment that is used to convert organic material into energy, or into methanol or any other synthetic fuel, should also be promoted. Deep-mining coal equipment produces coal, of which we have a continuing abundance, that might be used as fuel in replacement of our dwindling domestic supply of oil and natural gas fuels. Similarly, because of their importance as an energy-efficient method of transportation and because of their importance in the movement of coal, the committee believes the modernization of railroad facilities is also to be encouraged. (The railroad provisions of the committee amendment are discussed above in the section on *Capital Formation.*)

No comparable provisions are included in the current House bill. However, the committee's amendment reflects agreement with the objective in the House-passed energy tax bill (H.R. 6860) in providing tax incentives to various types of property to expand the nation's supply of energy sources.

The House energy tax bill would permit 5-year amortization (in lieu of regular depreciation) for the capital cost of the equipment to be encouraged. This equipment related to waste-burning and recycling equipment, solar energy equipment, coal slurry pipelines, oil shale, coal gasification and liquefaction facilities, solar energy equipment, equipment used in deep-mining coal, and certain railroad equipment and rolling stock. Taxpayers, however, who would elect a 5-year rapid writeoff under the House bill would have been entitled to an investment credit of only two-thirds of the cost of the property. In many (if not most) cases, taxpayers would receive greater tax benefits by depreciating the property under the double-declining balance method over the property's guideline or ADR life and thereby also retaining a full investment credit. The committee did not consider this rapid amortization to be sufficient additional incentive to bring about the desired increase in energy conservation investments.

Explanation of provisions

The committee amendment replaces the amortization provisions in the House energy tax bill (H.R. 6860) with an increase in the investment credit to 12 percent for certain kinds of energy property.[1]

The committee amendment extends a 12-percent investment credit for a period of 5 years to machinery or equipment necessary to permit waste (or a combination of waste and other fuels) to be used as a fuel. This use as a fuel includes both waste burning and the manufacture of synthetic fuels from solid waste. The increased credit is to be available only for so much of the property as is necessary to facilitate the use of waste as a fuel or the addition of waste to fuels and is also available to equipment used to recycle solid waste or to prepare solid waste material for recycling. In order to encourage the conversion of organic materials, the committee amendment also provides a 12-percent credit for a period of 5 years for equipment used in the conversion of organic material into methanol or any other synthetic fuel which can be substituted for, or blended with conventional fuels. This credit covers equipment which uses organic material which is not waste but which has been grown for conversion to a fuel. In addition, a 12-percent investment credit is provided for a period of 10 years to oil shale equipment and coal slurry pipelines, as well as for coal liquefaction and gasification equipment and equipment to remove pollutants from coal. Further, the committee amendment makes available a 12-percent investment credit for a period of 5 years to machinery, equipment and structural components of underground coal mines.

The investment credit described above is to be available for any one or more of these types of energy conservation and production equipment. In the case of the above credits, an additional 2-percent credit is to be available for taxpayers who establish or maintain an employee stock ownership plan (ESOP) to which the employer contributes stock equal to 2 percent of the qualified investment in these energy properties. Each category of energy conservation and production equipment eligible for the 12-percent credit (other than railroad equipment) is further described below.

Waste conversion equipment

This type of equipment is defined as any depreciable machinery or equipment which is necessary to permit the use of waste as a fuel in a facility burning a combination of waste and oil as its principal fuel, which is used to process waste into a fuel, or which is used to sort and prepare solid waste for recycling or for use in recycling solid waste. Thus, the provision is intended to apply both to use of waste as a fuel and to the recycling of solid waste.

Under present technology, waste (primarily solid waste) that is properly sorted, classified, and shredded can be injected into a furnace to be used as a fuel in combination with oil or some other fuel in electrical generating facilities and sometimes in heating systems. In an efficient system, solid waste can replace as much as 20 percent of the oil which otherwise would be required as a fuel. In other situations wastes may be burned as fuel instead of oil after oil has been used initially to start the process. These uses of waste as a fuel not only pro-

[1] See also separate discussion above relating to credits for business insulation and solar and geothermal property.

vide an environmental sound method of disposing of the waste, but also can be used to reduce our reliance on oil as a fuel.

In the case of waste used as a fuel, the credit is limited to the additional machinery or equipment which is required to be added to an existing facility or to be placed in a new facility if waste is to be burned as a fuel. Thus, equipment that relates to the unloading and storage of waste fuel at the burning site, systems for feeding the shredded waste from the storage area to the furnace, and refuse firing ports to inject the waste fuel into the furnace are all eligible for the credit. In addition, machinery or equipment used to process waste into a fuel is to be eligible for the credit, regardless of whether the waste is to be used as the sole fuel or in combination with oil or other conventional fuels. In most operations, this would include equipment that takes solid waste which may be used as a fuel, sorts it from other wastes and puts it into whatever state, form, or shape is necessary for it to be used as a fuel. This process may involve, for example, compressing into logs or bricks, or baling.

The credit also is available for machinery and equipment that sorts and prepares solid waste material for recycling or that recycles solid waste. In the former case, there are machines that take municipal solid waste and separate, shred, and sort it into various classes of waste, such as paper, textiles, glass, ferrous metals, and nonferrous metals. Equipment to recycle solid waste paper, for example, includes equipment that reduces old newspapers, paperboard boxes and writing papers to a fibrous pulp and reconstitutes the pulp into paperboard. Recycling equipment also could be used to melt scrap metal and glass which would be refabricated (with or without virgin materials) into new metal and glass products.

Organic fuel conversion equipment

The bill allows a 12-percent credit for 5 years for organic fuel conversion equipment, which is defined to mean any depreciable machinery or equipment used in converting organic material (other than waste material) into energy or into methanol or any other synthetic fuel which can be substituted for, or blended with, any petroleum product for use as a fuel.

Deep mining coal equipment

Efforts to increase the uses of coal and increase coal mining capacity mean that industry must increase its capital investment in order to increase coal output and to do so at a faster rate than in the past. Present mining techniques also require newer and more sophisticated equipment. For example, the "longwall" method of mining uses an expensive shearing machine which cuts into the seam and creates a continuous stream of coal to be carried away on a conveyor belt. New techniques and machines are also being developed for detecting the presence and nature of underground coal from the surface and for removing sulfur from coal, the result of which will be to increase the demand and the supply of coal. Although coal is mined both on the surface and underground, the costs (and the geological difficulties and safety risks) are greater in trying to reach our enormous deep sources of coal. In many cases, this type of coal has higher energy and better bituminous quality (and lower transportation costs) than strip-mined coal.

The committee amendment allows a 12-percent investment credit for deep mining coal equipment for a 5-year period in recognition of the long period required for planning and bringing a new deep mine to full production. This provision covers depreciable equipment needed to reach underground deposits of coal in slope mines, shaft mines, or drift mines and to extract the coal and bring it to the surface.[2] It applies to whatever specific method is used in the underground mine (i.e., continuous and conventional mining and to the longwall and shortwall methods) and to the machines and equipment used in the process of actual mining, including conveyor belts, loading machines, and cars used to bring coal and miners out of the mine.[3]

The credit also applies to machinery and equipment used in newly opened mines, in new shafts or tunnels in existing mines and to reopened shafts or tunnels.

This additional 2-percent credit does not include property used in surface mining. The credit is not to be available for equipment used on the surface in removing earth and rock layers and removing coal lying close to the surface. This exclusion applies to contour and area mining and to auger mountaintop, open pit and similar types of strip mining, Also, the extra credit is not intended to be available for conveyor belts or similar means of transporting coal from the mouth of the mine to a preparation plant, or for other activities at the surface involving cleaning, concentrating processing, or loading coal for shipment from the mine site, nor is the extra credit to be available for reclamation equipment used at the surface. The extra credit is intended to be available, however, for machines used at the surface to locate underground supplies of coal or to analyze its content before actual extraction begins. The extra credit is also to be available for equipment used to prevent underground drainage or other defects in the mine or, where necessary or desirable, to seal it.

Coal liquefaction and gasification processing equipment

Commercially usable quantities of synthetic gas, crude oil, and other liquid fuels can be processed from solid coal. Low-sulfur gas, for example, can be obtained from coal either as pipeline quality gas (so-called SNG) or as a low BTU gas which has valuable uses to generate power. Synthetic crude oil usable as a fuel for firing generators or for heating purposes can also be processed from coal. Ash, sulfur and other pollutants can be removed from coal before burning through closed-system processes which produce solvent-refined coal. The committee believes that it is desirable to encourage such processes for using coal as a clean-burning fuel.

Although chemical processes to obtain clean fuels from coal have existed for over forty years, the technology required for commercial production has not yet been perfected. Nor have related water and plant construction problems yet been solved. However, Government-

[2] As used in the committee amendment, the shaft, drift, and slope techniques have the meaning generally assigned by the industry. A shaft mine is generally one in which a hole is excavated straight down to the coal seam, from which miners make horizontal entry through tunnels spreading out from the shaft. A drift mine develops coal beds in hillsides through an entrance horizontal to the coal seam and through which the miners make tunnels. A slope mine involves a slanted tunnel to reach coal beds in hilly areas where the seam is near the surface but too far underground for surface mining. The amendment also covers equipment used in an underground mine which has more than one of these types of openings. The term coal includes all types of coal as commonly known, including lignite, anthracite, and bituminous coal.

[3] Coal mining safety equipment also is to be applied to the credit provided by the committee amendment.

assisted or sponsored pilot projects, and private joint ventures, are presently in operation to find answers to these various problems.

In order to aid in the conversion of coal into gas or oil, the committee amendment permits a 12 percent investment credit for the capital cost of depreciable machinery or equipment fused. for processing coal into a liquid or gas. This provision covers the range of liquids and gases which can be derived from coal (as well as usable byproducts), including low-BTU gas, high-BTU gas, synthetic crude oils and chemical feedstocks. In addition to gasifiers, reactors, and other equipment directly involved in processing the coal, eligible machinery and equpment includes the facilities for coal preparation and crushing; for upgrading coal oil to synthetic crude oil; for recovering solvent and sulfur; for preparing and disposing of water; and for product storage. Equipment used to drill wells, or to fracture coal in a mine and to pipe process gas to the surface, as part of underground gasification is also included. The credit is also to be available for equipment used in the solvent refining process to remove sulfur, ash or other pollutants in order to produce a clean solid fuel from coal.

The provision also permits machinery and equipment used in demonstration and pilot plants and in other testing activities (as well as machinery and equipment used in commercial production) to receieve the extra credit if the equipment is the type that, if used in a trade or business, would be depreciable.

The credit is not the be available, of course, if the item of cost incurred by the taxpayer is deducted in a taxable year (See Regulations section 1.48–1(b)(3)). Also, the credit is not to be available with regard to any monies granted to the taxpayer by the Federal Government. The credit may be claimed, however, with respect to funds borrowed from the Federal Government or borrowed under a Federal guarantee of the loan. In addition, the credit also does not extend to the refining of synthetic crude oil or to the outside structure or shell of a processing plant.

Coal pipeline equipment

One of the most promising ways in which our country can obtain increased coal supplies is to increase production in areas where coal is not now extensively mined. Coal reserves in Rocky Mountain area coal fields, such as in Montana, Wyoming, and Colorado, are especially important in this regard, because such coal is generally easier to mine than Eastern coal and also because of its low sulfur content. Transportation, however, is always an important factor in coal mining and particularly in obtaining the benefits of increased mining of Western coal. To help solve delivery problems, while minimizing adverse environmental effects of increased coal production, Government and industry are becoming increasingly interested in long-distance coal slurry pipelines as an addition to rail or barge transport.

A slurry pipeline pumps finely ground coal as a mix of a solid (coal) and a liquid (usually water) from the mine to a user of the coal, such as a utility, or to barges or railroads for further shipment.

At the other end the coal is dried and used as fuel in coal-fired electric generating plants. Several slurry pipelines (some carrying coal and some carrying other materials such as limestone) are already in operation in the United States and in other countries.

The committee amendment provides a 12-percent investment credit for costs incurred at any time during a 10-year period in installing pipeline equipment to carry coal in a slurry. Although moving coal by slurry involves an entire system of related machinery and equipment (e.g., water supply facilities, grinding and testing equipment, and holding tanks in slurry preparation plants), the committee intends that the credit be confined to the central elements of the slurry system; namely, the main pipeline itself, the high-pressure main pipeline pumps (including spare pumps) necessary to move the coal through the line, and control and communications equipment for operating the pumping stations. The costs of these components, according to some estimates, is approximately one-half or more of the cost of the entire system.

The amendment defines an eligible pipeline as depreciable tangible property which constitutes a coal slurry pipeline and related equipment for transporting coal from the mine or other gathering point. By this definition, the committee intends to cover only pipelines which transport coal over relatively long distances from the mine (or from a related preparation plant) to another geographical area where the customers is located or where barges, rail lines, or other facilities for further shipment of the coal are located. This provision would not apply to short-distance systems designed to move coal within a coal preparation plant or within other integrated facilities where slurry is moved from one point to another in a commercial or industrial process. Pipelines for the transport of materials other than coal in a slurry are also not covered by the provision. Also not included in the provision is the slurry preparation plant or equipment used in the plant, water supply facilities, or storage and holding tanks, dump ponds and other items at the pumping stations (apart from the pumps). Nor would the provision cover dewatering and drying equipment or other facilities after the slurry emerges from the pipeline.

The provision is intended to be broad enough, however, to cover pipeline transportation of coal mixed with liquids other than water (such as oil or gas), and also in such other ways as improved technology may permit, such as moving coal through the pipe by air pressure. In the case of such other mixtures, the provision in the amendment would cover compressors, feeders, and other equipment equivalent to pumps in a coal-water slurry, which perform the function of moving the coal through the pipe.

Shale oil conversion equipment

The extraction of fuels from shale rock offers a long-term prospect of making shale oil an important domestic source of energy to supplement conventional oil and gas production. Oil shale is a sedimentary rock, much of which is underground, from which crude oil and gas can be extracted by the application of heat. The characteristics of these shale fuels match conventional natural gas or oil in many respects and make them usable in place of natural fuels for many purposes. The United States has large estimated reserves of shale rock, particularly in Colorado, Utah, and Wyoming, but there is yet no commercial production of oil or gas from this source. At the present time several companies are engaged, individually and through joint ventures, in test projects which are necessary before commercial production can occur. These activities include measuring the net energy gains involved in shale oil recovery, collecting baseline data on air, water, and disposal problems, and perfecting the processes for extracting oil from the rock. Several different techniques for removing oil from shale are in the experimental stage, but no one method has as yet proven to be commercially sound. (Some techniques involve conventional underground excavation and processing in above-ground plants; others involve surface mining in open pits; still others involve fracturing the rock in underground caverns and then heating it in place in order to remove the oil (the so-called *in situ* method)).

The committee believes that commercial production of shale oil should be encouraged as an additional energy source. In order to provide a further incentive to reach this goal, the bill permits a 12-percent investment credit for capital expenditures paid or incurred during a 10-year period for machinery or equipment which, if incurred in a trade or business, is or would be depreciable and which is necessary to reach, extract and convert shale rock into raw shale oil. The provision does not cover expenditures for refining crude shale oil after it has been extracted from the rock. However, it is intended to cover machinery and equipment used to obtain water needed for the extraction process, to dispose of spent shale after the oil has been extracted, to dispose of run-off waters from wastes produced in the extraction, and to remove impurities from oil and gas produced from the shale. This provision also permits machinery and equipment used in demonstration and pilot plants for shale oil extraction to receive the 12-percent credit, provided that the taxpayer's cost is not expensed rather than recovered through a method of depreciation, and provided that the cost as to which the credit is applied does not include grants received from the Federal Government.

Other provisions

Regulations.—The committee amendment specifically authorizes the Secretary of the Treasury to prescribe by regulation the further rules needed to carry out the purposes of this provision.

Employee stock ownership plans.—In addition to the investment credit rate made available by the committee amendment for the types of energy property described above, a corporate taxpayer may claim an additional 2-percent investment credit if the taxpayer establishes or maintains an employee stock ownership plan, to which the taxpayer contributes an amount equal to the 2 additional percentage points. The base on which the additional 2 percentage points is to be computed is the aggregate qualified investment of the taxpayer (as determined under the rules of present law in section 46 (c) and (d) of the Code) in one or more of the energy properties covered by this provision. The requirements for the type of employee stock ownership plan which must be established or maintained under this optional extra credit are described in section 301(d) of the Tax Reduction Act of 1975 (P.L. 94–12, 89 Stat. 26).[4] The taxpayer's election to use the additional 2-percent credit must be made in the form and at the time that the Secretary specifies by regulation.

Tennessee Valley Authority.—The Tennessee Valley Authority (TVA) makes annual payments to the Federal Government as a return

[4] As amended by the committee amendment relating to ESOPs, described above under *Capital Formation.*

on the investment in power facilities that was made by appropriation of Federal funds. TVA also competes with private electric utilities in providing electric energy. TVA and its competitors have made investments in the same kinds of facilities that are used to provide and transport fuel to generating stations and distribute electric energy to consumers. The competitors are eligible for the investment credit which reduces the investors' cost of capital and may be reflected in their price for electric energy. In order to equalize the competitive positions of all the electric companies in the area where TVA operates, the committee amendment makes the TVA eligible, in effect, for the special 12-percent credit provided by a new section 46A of the Code with respect to investments in such energy-conserving equipment as organic fuel conversion equipment, coal processing equipment, coal pipeline equipment, and shale oil conversion equipment.

Under this amendment, credits earned by TVA for purchases of the equipment described above may be deducted from the payments it makes to the Federal Government as return on the appropriation investment in power facilities and the annual repayment sum. Credits earned in any fiscal year that are in excess of the sum of payments and repayments for that fiscal year may be carried over to the following fiscal year under existing rules for carryover of investment credits. If the excess credit is not used in the following fiscal year, it will no longer be available to reduce the payments to the Federal Government.

Effective date

The 12-percent investment credit for waste conversion equipment and organic fuel conversion equipment applies to property acquired after December 31, 1976, and placed in service by December 31, 1981. The 12-percent credit for coal processing equipment, coal pipeline equipment, deep mining coal equipment and shale oil conversion equipment applies to property acquired after December 31, 1976, and placed in service by December 31, 1986.

The Tennessee Valley Authority provision applies to payments made to the Federal Government for the fiscal year beginning on October 1, 1976, and thereafter.

In the case of each qualifying type of energy property, the acquisition requirement will be satisfied if the construction, reconstruction, or erection of the property (whether or not by the taxpayer) begins after the applicable effective date. If a taxpayer has not placed property in service by the last date permitted under the above rules for doing so, rules similar to the rules in present law relating to termination of the investment credit between 1969 and 1971 (sec. 49) are to be prescribed by the Service for determining the credit amount that will be allowed. Finally, if a taxpayer claims an investment credit under this provision but uses the property before the end of its useful life in a way other than that for which the credit was allowed, the taxpayer is to be treated as having made a disposition of the property on the date on which the other purpose or use substantially began. (As such, the disposition rules of sec. 47 will be applied under regulations to be issued by the Service.)

Revenue effect

The increase in the investment credit for qualified waste-burning equipment will reduce budget receipts by $2 million in fiscal year 1977 and $5 million a year thereafter. The higher investment credit for oil shale production equipment will reduce budget receipts by $4 million in fiscal year 1977, $13 million in fiscal year 1978 and $20 million in fiscal year 1981. The higher investment credit for coal slurry pipelines will reduce budget receipts by $7 million in fiscal year 1977, $17 million in fiscal year 1978 and $28 million in fiscal year 1981. The higher investment credit for deep-mining coal equipment will reduce budget receipts by $11 million in fiscal year 1977, $27 million in fiscal year 1978 and $42 million in fiscal year 1981. The other provisions will have effects on budget receipts of less than $5 million.

7. Deductions for Production and Intangible Drilling Costs of Geothermal Steam and Associated Resources (sec. 2004 of the bill and new sec. 191 of the Code)

Present law

Present law is unsettled as to whether a depletion deduction or the intangible drilling cost deduction is allowable for the production of geothermal steam and associated geothermal resources. These questions were answered affirmatively for the taxpayers in the case of *Reich v. Commissioner*, 454 F.2d 1157, 29 A.F.T.R. 2d 72–512 (C.A. 9, 1972).[1] However, the Internal Revenue Service is apparently not following that decision in cases arising outside of the Ninth Circuit.

The Tax Reduction Act of 1975 (94th Congress), generally eliminated the depletion allowance for oil and gas, except for a continued allowance for small producers. However, the depletion allowance for geothermal resources was not to be affected by that Act. According to the Conference Report (H.R. Rep. No. 94–120, p. 67):

> For geothermal steam, present law is unaffected, so that if steam is ultimately held by the courts to be a gas entitled to a 22-percent rate of depletion, this treatment will be continued.

As a result, the 22-percent depletion deduction allowable to gas wells immediately prior to the 1975 Tax Reduction Act is still available for geothermal energy if courts should decide, as did the *Reich* court, that a geothermal well is a gas well, and that the other requirements for depletion are met.

Under current law it is also possible that to the extent the costs of geothermal energy development (including intangible drilling and development costs) result in new processes or technology, they would be considered as research and experimental expenditures subject to the election to be currently deductible or to be amortized over a 60-month period commencing when the taxpayer begins to receive benefits from the expenditure. The Internal Revenue Service has ruled in Revenue Ruling 74–67, 1974–1 C.B. 63, that certain costs of developing a method for hydraulic mining of hard minerals, including a portion of the costs of drilling wells, are deductible as research and experimental expenditures. However, under present law the costs of as-

[1] In the *Reich* case, the Tax Court had held that the product of the taxpayers' geothermal steam wells was a gas, and that the taxpayers as a result were entitled to expense currently their intangible drilling costs (sec. 263(c) of the code). The court held further that the plaintiffs were entitled to the then 27½ percent depletion deduction allowance for their product because (1) their product was steam, not inexhaustible earth heat, (2) the particular geothermal wells in question were exhaustible, (3) steam is a gas, and (4) the exclusion from the right to depletion of "water" in section 613(b)(7) of the code does not exclude steam from the depletion allowance.

certaining the existence, location, extent, or quality of any deposit of oil, gas, or other mineral are not deductible as research and experimental expenditures.

Reasons for change

The Project Independence goal for electrical generation through geothermal resources is 20,000 megawatts of electrical generating capacity by 1985. This amount—five percent of current national electrical capacity—represents the equivalent of almost 300 million barrels per year of low sulfur crude oil. It has been estimated that achieving the 1985 goal includes the costs of drilling at least 800 exploratory wells and 6,000 developmental wells at a minimum cost of $50,000 per well, or a total of $3.4 billion in 1975 dollars in drilling costs alone. Depreciable investment in hook-up facilities will add another $2 billion. Moreover, some 2.000 replacement wells will be required, with the attendant depreciable investment, bringing the total investment requirement to about $10 billion.

Nevertheless, only 38 geothermal wells were drilled in the United States through July, 1975. It is projected that there will be another 12 in 1976, making a total of 50 wells. It is anticipated that next year there will be approximately 75 geothermal wells drilled. That will be a total of 125 wells, as compared with the estimated need of 800 exploratory and 6,000 developmental wells needed if the Project Independence goal is to be met.

It appears to the committee, therefore, that the Project Independence goal can be met only by legislation granting to geothermal production intangible drilling expensing and the depletion allowance, or an equivalent deduction. It appears that this explicit tax incentive will produce the considerable necessary investment.

Explanation of provision

The committee amendment extends current expensing of intangible drilling costs and an additional deduction for 22 percent of the gross income from the property [2] to the production of geothermal steam and associated geothermal resources. This deduction is not to exceed 50 percent of the taxpayer's taxable income from the geothermal steam and associated geothermal resources property for the taxable year, computed without regard to this 22 percent deduction. The normal depletion deduction (section 611), however, is not allowed if a deduction under this provision is allowable. Thus, there cannot be any double deduction in the nature of depletion allowances regardless of whether the Internal Revenue Service or the necessary courts should determine ultimately that geothermal production is entitled to the depletion allowance.

It is intended that the term "22 percent of the gross income" is intended to mean the fair market value of the geothermal steam and associated geothermal resources at the wellhead. Thus, the gross income for which the percentage deduction is granted is not to include expenses of selling the steam or other geothermal resource such as costs of bringing the steam to the consumer.

The committee decided to provide a new deduction for this fledgling

[2] "Property" is to have the meaning given it in section 614 of the code, which is to say that it means, in general, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

industry, rather than to clarify the existing sections of the code pertaining to depletion. This is done to avoid some of the technical questions which traditionally surround the depletion allowance. For example, this approach permits the steam or other geothermal resource to be entitled to the new deduction whether or not the steam or other geothermal resource from the property in question is exhaustible in nature.

The term "geothermal steam or associated geothermal resource" is the term used in the Geothermal Steam Act of 1970. In accordance with a number of the definitional provisions of that Act, the committee intends the term "associated geothermal resource" to include hot brine, dry heat (that may be produced with the use of such a substance as freon) and hot water (such as that which may be used directly to heat a building equipped with a heating unit employing hot water heating) and the other resources included in that Act. However, the tax benefits conferred by this amendment are not to extend to such minerals as are sometimes produced in the course of geothermal production, such as sodium, calcium, and trona. Furthermore, the term "geothermal steam and geothermal resources property" is to mean property from which the taxpayer extracts any product included in geothermal steam and associated geothermal resources, as defined by the Geothermal Steam Act of 1970.

The amendment specifically provides that in order to be eligible for this deduction, the taxpayer must be the holder of an "economic interest" in the geothermal energy property. The committee believes this is necessary to insure that the party who is taking the deduction did not acquire a mere economic advantage in the property in order to qualify for the deduction. The term "economic interest" as used in this amendment should be given the same meaning as the term has for purposes of computing depletion in the case of oil or gas wells.

Although the deduction provided for in this amendment is termed a "business deduction", it is to be allowable to the holders of passive interests in a geothermal energy property, such as holders of a landowner's retained royalty, an overriding royalty, or a net profits interest. It is not to be limited to holders of an operating interest, such as a working interest in the property.

The deductions of section 617 of the code for expenses paid or incurred for mining exploration before the beginning of the development stage of the mine are not to be allowed to geothermal production which enjoys the benefits of the current expensing of intangible drilling costs and the 22-percent deduction provided by this provision.

The 22-percent deduction provided in the committee amendment is to constitute an item of tax preference (under section 57(a)(8) of the Code) for purposes of the minimum tax on tax preferences. Thus, the excess of the deduction over the adjusted basis of the property at the end of the taxable year (determined without regard to this deduction) is an item of tax preference.

In the case of leases, the new 22-percent deduction is to be apportioned between the lessor and the lessee. In the case of property owned for life by one person, with the remainder owned by another, the entire deduction is to be allowed to the life tenant. In the case of property held in trust, the deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the trust provisions, or, if there are none, on the basis of the trust income allocations. In the case of an estate, the deduction is to be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

Effective date

The amendments made by this provision are to apply to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that current expensing of intangible drilling costs of geothermal properties and the deduction for 22 percent of gross income from geothermal properties will reduce receipts by $7 million for fiscal 1977, $15 million for fiscal 1978, and $21 million for fiscal 1981.

8. Denial of Investment Credit for Certain Air Conditioning and Heating Units (sec. 2005 of the bill and sec. 48 of the Code)

Present law

Under present law, central air conditioning or heating units are not eligible for the investment credit to the extent these units are attached to and become a part of a building or structure.[1] However, self-contained and portable-type heating and air conditioning units which are not permanently attached to a building, such as room air conditioners and space heaters, do generally qualify for the investment credit.[2]

Reasons for change

The committee has noted that portable heating and cooling equipment which is presently eligible for the investment credit tends to be less efficient in terms of energy consumption when compared to central heating or cooling systems. The committee also considers that the availability of the investment credit (particularly in light of the increase in the credit to 10 percent) encourages the acquisition of these less efficient air conditioning and heating units.

Explanation of provision

In order to eliminate the investment credit as a factor considered by a business purchaser of heating and cooling equipment, this section provides that portable air conditioning and heating units will no longer be considered to be qualifying property for purposes of the investment credit.

This elimination of the credit is intended to apply only in situations where air conditioning or heating units are acquired and placed into service for the predominant purpose of human comfort. For example, an air conditioning unit placed into service predominantly to cool a room which houses computers or other equipment requiring certain atmospheric conditions to function properly remains eligible for the investment credit (if it otherwise is qualifying property) even though the equipment serves a secondary purpose or function of providing more comfortable working conditions for persons working in the room. This provision is also not intended to apply to equipment, such as fans, which perform general heating or cooling functions by circulat-

[1] Reg. § 1.48–1(e).

[2] Rev. Rul. 75–77, 1975–10 I.R.B. 6.

ing the air. However, fans which are an integral part of heating or cooling units, such as the fans in room air conditioners or space heaters, are considered parts of thees units and will therefore not be eligible for the investment credit.

Effective date

This provision will apply to air conditioning or heating units, either new or used, placed in service by the taxpayer after December 31, 1976.

Revenue effect

The effect of this provision is estimated to be a revenue gain of less than $5 million per year.

9. Recycling Tax Credit (sec. 2006 of the bill and secs. 38 and 46 of the Code)

Present law

There is no provision in present law for a recycling tax credit or any other tax incentive to encourage salvage and reclaiming of materials as a means to conserve natural resources, reduce energy consumption, and reduce environmental litter. In sections 611 and 613 of the Code, a schedule of percentage depletion rates is provided for various metals and minerals to encourage their discovery, development and mining so that the metals and minerals may be made available for industrial use. Percentage depletion also is provided to the owners of these materials because they are irreplaceable assets. Capital gains treatment is available on timber income and on royalties from coal and iron ore.

Reasons for change

Concern with the decreasing domestic reserves of petroleum and natural gas has focused attention on ways to conserve the supply of these natural resources and to reduce the rates of their consumption as fuel and as other forms of energy in industrial activity. One way to achieve this objective is to reuse the metals and other materials through recycling processes appropriate to each of the products. Energy and fuel savings occur because mining, refining, and possibly, some of the initial manufacturing processes need not be repeated. For many of the products, recycled products shortcut the full manufacturing process and enter the manufacturing stream one or two stages before the basic material, for example, aluminium or copper, is fabricated into a finished or semi-finished product. Furthermore, many of these products can be recycled many times without loss of their innate characteristics.

Other benefits accrue from increased recycling. Where imports account for significant percentages of U.S. consumption of virgin materials, recycling these materials would provide domestic substitutes for the imports and might tend to have favorable effects on the balance of payments. Furthermore, depletion of natural resources would be slowed as increasing amounts of recycled materials could be used as substitutes for virgin materials. Similarly, the revenue loss from a recycling tax credit need not produce a net decrease in budget receipts, if there is sufficient substitution of recycled materials for virgin materials to produce a decrease in revenue loss from percentage depletion allowances.

Serious problems of environmental damage could be reduced to the extent that increased recycling reduces random discarding of bottles, cans, paper and other products on streets, highways, and the countryside. The volume of municipal solid waste requiring disposal through use as land fill or by incineration also would be decreased.

During its executive sessions on H.R. 6860 last year, the committee recognized the desirability of stimulating greater activity in recycling discarded materials. At that time, it gave tentative approval to a 10-percent credit on the purchase of recyclable waste paper by a recycler. The committee did not complete its consideration of whether to extend the recycling credit to other materials and to metals.

Explanation of provision

The committee amendment provides a tax credit to a recycler for purchases of recyclable solid waste materials. The credit is available for qualified recycling purchases that exceed 75 percent of the base period amount.

A qualified recycling purchase is defined as the amount paid or incurred by the taxpayer who is a recycler to purchase recyclable solid waste material which is to be recycled in the United States for use in the United States. This credit would not be available for the portion of recycled materials and products which the recycler exports or sells for export. If the recycler, for example, sells 25 percent of his aluminium ingots made from recycled aluminium to an exporter, the recycler will be eligible for only 75 percent of the recycling credit he has earned on the basis of his purchases of recyclable aluminium waste.

The amount of the credit for ferrous and nonferrous metals would be one-half of the percentage depletion allowance provided for them under section 613. Textile and paper waste would receive a 10-percent credit and glass and plastics would be eligible for a 5-percent credit. No credit is allowed for recycling gold, silver, platinum, or other precious metals. The credit allowed for paper waste would be limited by a range with a minimum credit of $5.50 per ton and a maximum credit of $8.00 per ton, and these limits would increase annually by the same percentage as does the consumer price index for all items.

The committee was concerned that the recycling tax credit be used to stimulate a steadily increasing amount of recycling of solid waste materials and that the credit should not become a windfall for people already in the recycling industries. Accordingly, it provided for a base period that would limit the credit to increased recycling production. It also provided a phase-in of the credit for new and existing producers during the first 2 years after enactment.

For recyclers who were in operation before 1973, the base period amount would be 75 percent of the average annual purchases for the calendar years 1973, 1974, and 1975. This base period would be in effect through December 31, 1980. After that date, the base period would be the 3 taxable years preceding any particular taxable year. The base period amount then would become 75 percent of the average annual purchases during the 3-year periods. As a result, the base period would become a moving average which would serve even more effectively to make the credit available for increases in recycling activity. The 3-year moving average would tend to reduce the range of fluctuations normally associated with cyclical economic activity, and the recycler whose recycling activity was increasing would have reasonable assurance that he could continue to earn recycling tax credits.

Recyclers who were producing during the 1973–75 base period but had no production during one of the years would include that year as one year with zero purchases in the 3-year period in determining the average annual amount of purchases for the base period. Where the recycler has only part of a year's production in one of those years, he would annualize the part year's activity. To annualize his purchases, the taxpayer would multiply the number of days of production by the ratio of 365 to the number of days in the calendar year during which production occurred.

For example, if production began on September 16, and continued through the rest of the year, recycling would have been carried on for 107 days, and the ratio for annualizing the purchases for that year would be 365/107 or 3.41. In order to avoid a situation where the operation of the annualizing process materially distorts the purchases that would have been made for that period, the Secretary is authorized to increase or decrease the annualized amount.

For a new recycler after 1975 who must establish a base period, the base period amount in his first year of recycling production would be zero because he has no prior year's experience and all recyclable solid waste material purchased in the first year is an increase. For his second year of production, the base period amount would be 75 percent of the first year's purchases divided by 3. For the third year, the base period amount would be the purchases in the first 2 years divided by 3, and for his fourth year of production, he would have 3 years of prior activity to establish a base period. When the first three years occur before January 1, 1981, they would become the fixed base period until the moving average base period goes into effect.

The recycling credit is phased in during the first 3 years for which it is effective. The phase-in provision limits the recycling credit in the first year to 25 percent of the amount determined under the rules described above and to 50 percent in the second year. The full amount of the credit earned by qualified purchases would be available for the third and subsequent years. The 25-percent limit would apply for taxable years beginning after December 31, 1976, and before January 1, 1978. The 50-percent limit would apply for taxable years beginning after December 31, 1977, and before January 1, 1979.

Recyclable solid waste materials are defined as materials which must have been used by an ultimate consumer and have no significant value or utility except as waste. The ultimate consumer may be a household that discards newspapers, boxes, soda pop, and beer containers made from glass, plastic, aluminum, and other metals, and worn-out clothing. Scrap paper, boxes, and all other containers discarded as waste from residential, office, and commercial buildings also qualifies. Discarded containers from industrial plants also are wastes that have been used by an ultimate consumer.

Waste from industrial processes also may be recyclable solid waste materials. A manufacturer may be an ultimate consumer when he purchases raw materials which he fabricates into a new product. Wastes that result from his fabrication process may be classified as postconsumer solid wastes. To qualify as a purchase for recycling, the waste material must not be reusable by the fabricator in his process, and neither the fabricator nor a related person may be engaged in the manufacture of such material or in processing the waste material.

For example, assume that a printer of books or magazines generates waste paper from trimmings and cuttings as the printed material is assembled and bound. The printer is to be considered as an ultimate consumer, if the trimmings and cuttings are wastes from his plant that he cannot use again in printing, and he sells the wastes to a recycler. The recycler must be an independent entrepreneur, unrelated through ownership relations, who may put the paper wastes through a paper-making process for the manufacture of a paper product.

The term recyclable solid waste materials does not include any material that becomes a component part of the property eligible for the investment credit under section 38 when it is in the hands of the taxpayer who recycles the material. The recycler may employ the material which he recycles to manufacture equipment that, after sale, becomes section 38 property in the hands of another taxpayer.

Recycling means to subject the post-consumer solid waste material to a treatment which alters the composition or physical properties of a material, and which transforms the material into a product or material which does not constitute recyclable solid waste. Recycling does not include a process consisting merely of sorting, shredding, stripping, compressing, and packing for storage and shipment. Melting discarded beer cans or bottles into molten metal or glass that is used to fabricate new metal or glass products, including cans or bottles, qualifies as recycling. Breaking glass waste into parts, cutting metal into pieces or shredding paper before any of these wastes actually are transformed through a mechanical or chemical process into a form from which new products may be fabricated do not qualify as recycling.

A purchase is not a qualifying purchase if the waste material is acquired from a relative, a corporate affiliate or subsidiary, or in a tax-free exchange. The term purchase has the same meaning with respect to the recycling tax credit as it does under section 179(d)(2) of the Code, relating to acquisitions from family members, related business enterprises, etc.

Effective date

This provision applies to materials purchased for recycling after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by $9 million in fiscal year 1977, $39 million in fiscal year 1978, and $345 million in fiscal year 1981.

10. Repeal of Manufacturers Excise Tax on Buses and Bus Parts (sec. 2007 of the bill and sec. 4061 of the Code)

Present law

Under present law, a 10-percent manufacturers excise tax is imposed on the sale of buses having a gross vehicle weight of more than 10,000 pounds (sec. 4061(a)).[1] However, present law provides for an exemp-

[1] This tax is scheduled to drop to 5 percent on and after October 1, 1979.

tion from this tax "local transit buses"; that is, those "which are to be used predominantly by the purchaser in mass transportation service in urban areas" (sec. 4063(a)(6)).[2] The tax also does not apply to school buses for "exclusive" use in transporting students and employees of schools operated by State or local governments or by nonprofit educational organizations (sec. 4221(e)(5)).[3]

In addition, there is an 8-percent manufacturers excise tax on parts and accessories (other than tires and inner tubes, which are taxed separately under sec. 4071) of the type used on buses (sec. 4061(b)).[4]

Reasons for change

The committee considers it desirable to encourage the use of bus transportation because it is a more energy-efficient mode of transportation. In addition, the committee believes that the tax distinction between local transit buses and intercity buses (scheduled and charter) should be removed, as both types of bus transportation conserves energy as compared to private auto transportation (upon which there is no manufacturers excise tax on the purchase). Further, since timely use of bus replacement parts and accessories contribute to efficiency of operation and vehicle safety, the committee believes that the 8-percent tax also should be repealed for bus parts.

Explanation of provision

The committee's amendment repeals the excise tax on all buses as well as the related tax on bus parts and accessories. The House energy tax bill (H.R. 6860) provided for a repeal of the 10-percent excise tax on intercity-type buses only; that is, buses which would be used "predominantly by the purchaser in public passenger transportation service."

The committee's amendment extends the repeal to all buses in order to remove any tax discrimination among types of buses, as well as to reduce the administrative problems regarding the present distinction between buses used "predominantly" in local transit service in urban areas and transit buses not so used as well as between buses used "exclusively" for school transportation and those that are not.

The repeal of the excise tax on bus parts applies only to parts designed and ordinarily used for buses, as contrasted to parts for trucks.

Effective date

The repeal of the 10-percent excise tax on buses and the 8-percent excise tax on bus parts is effective for sales by the manufacturer, producer, or importer on or after July 1, 1976. An article is not to be considered as sold before the date of enactment unless possession or right to possession passes to the purchaser before that time.

In the case of partial payments of tax in connection with leases, certain types of installment sales, conditional sales, or certain types of chattel mortgage arrangements, present law (sec. 4216(c)) provides that the manufacturers excise tax is to be paid upon each partial payment and is to be based on the tax rate in effect on the date each partial payment is due. To avoid windfall benefits to a manufacturer where the lease, installment sale, etc., took into account the 10-percent tax, the

[2] This exemption a pplies to privately-owned local transit buses, since "public" transit buses are exempted under the State-local government exemption provision (sec. 4221(a)(4)).

[3] This applies to persons purchasing school buses for contract operation to transport school students or employees, as school buses sold directly to State-local governments or to nonprofit educational organizations for their exclusive use are exempted already (sec. 4221(a)(4) and (5)).

[4] This tax is also scheduled to be reduced to 5 percent on October 1, 1979.

amendment provides that no tax is due on partial payments on or after the date of enactment if the lessor or vendor establishes that the amount of the payments payable after that date has been reduced by the amount of tax that would otherwise have been due with each partial payment after that date. If the lessor or seller does not establish that the payments have been so reduced, the tax reduction provided by the bill is not to apply to the article on which those partial payments are being made. In other words, for the tax reduction to be available in partial payment cases, the benefit of the repeal must be passed on to the lessee or purchaser.

Revenue effect

It is estimated that this provision will reduce receipts by $19 million for fiscal year 1977, $20 million for fiscal year 1978, and $12 million for fiscal year 1981.

11. Excise Tax on Rerefined Lubricating Oil (sec. 2008 of the bill and sec. 4093 of the Code)

Present law

Present law imposes a 6-cent-per-gallon manufacturers excise tax on the sale of lubricating oil (other than cutting oils) in the United States (sec. 4091). Sales to a manufacturer or producer of lubricating oils for resale are exempt (sec. 4093). The cleaning, renovating, or refining of old oil is itself not considered to be manufacturing (Treas. Regs. § 48.4091-2(b)(2)(ii)), and as a result the sale of rerefined oil by the rerefiner does not result in a tax.

A refund or credit of the tax is authorized in the case of lubricating oil used otherwise than in a highway motor vehicle. The refund or credit is not allowed, however, for cutting oils, previously used oil, or other oil which was exempt from the excise tax. Present law (sec. 4218(a)) also provides that if a person uses an article that he has manufactured, produced, or imported, he is generally liable for the manufacturers tax in the same manner as if he had sold the article, unless he uses the article in the manufacture of products that are themselves subject to the manufacturers excise tax. As a result, a manufacturer of lubricating oil may be liable for the manufacturers excise tax of 6 cents per gallon if he himself uses the oil, rather than sells it.

The Internal Revenue Service has ruled (Rev. Rul. 68-108, 1968-1 C.B. 561) that if a person uses new lubricating oil off the highway (e.g., in railroad lubricating activities), then he is entitled to a full refund of the manufacturers tax. Indeed, the railroad may purchase it tax-free pursuant to a registration system. However, if a person mixes waste or rerefined oil with new lubricating oil, then the new lubricating oil portion of the mixture is taxable. Also, the railroad or other ultimate user of the mixture for nonhighway purposes is not permitted to obtain a refund of the tax paid on the new portion of the oil mixture that is so used.

Reasons for change

The tax laws as interpreted by the Internal Revenue Service at present provide a disincentive to the use of waste or rerefined oil. In order to remove this tax incentive to the use of waste or rerefined oil, the committee believes that an exemption from the tax for new oil mixed with waste or rerefined oil should be provided under certain circumstances.

Explanation of provision

The committee amendment exempts from the 6-cents-per-gallon excise tax new oil used in combination with old oil for new oil constituting up to 55 percent of the mixture. The House bill did not contain a comparable provision. This same provision, however, was contained in the House-passed energy tax bill (H.R. 6860).

More specifically, new oil is exempt from tax when mixed with waste or rerefined oil if the resulting mixture contains up to 55 percent new oil, then all of this new oil in the mixture is to be tax-exempt. If the mixture contains more than 55 percent new oil, the rerefiner is still to be exempt from tax on so much of the new oil as does not exceed 55 percent of the mixture. However, in order to insure that this provision operates in a manner which requires the use of a significant amount of waste or rerefined lubricating oil, the tax exemption for the new oil is available only if 25 percent or more of the mixture consists of waste or rerefined oil.

In determining the percenatges of new and previously used oil in the blend, the amount of any additives in the rerefined oil is not to be taken into account. In other words, the base 100 percent of the blend on which the portions of previously used oil and new oil are to be calculated for the purpose of determining the exemption is to be the total amount of the blended product, less any additives.

The exemption of new oil in the mixture is achieved by classifying sales to rerefiners as sales to a producer of lubricating oil for resale by him. As a result, these sales will be tax-exempt, since sales to producers are exempt under present law (sec. 4093). However, if a sale is made to a rerefiner, part or all of the new oil included in the blend may be taxable if the blend consists of more than 55 percent virgin oil. In this case the rerefiner is liable for the resulting tax because he is treated as the manufacturer of the blend.

This provision is not intended to affect the present power of the Commissioner of Internal Revenue to issue certificates of exemption (from the sec. 4091 tax) for sales of oil suitable for lubricating purposes, but which are sold directly by the manufacturer to a purchaser for nonlubricating use by him or for resale for nonlubricating use.

Effective date

The exemption for certain new oil applies to lubricating oil sold after June 30, 1976.

Revenue effect

It is estimated that this provision will reduce receipts by about $3 million a year. These revenues would otherwise go into the Highway Trust Fund (through September 30, 1979).

12. Exemption From the Retailers Excise Tax on Special Motor Fuels for Certain Nonhighway Use (sec. 2009 of the bill and sec. 6427(c) of the Code)

Present law

Present law imposes a retailers excise tax of 4 cents a gallon upon diesel fuel and certain other special motor fuels [1] where the fuel is sold

[1] The special motor fuels are benzol, benezene, naphtha, liquified petroleum gas, casing head and natural gasoline or any other liquid (other than kerosene, gas oil, fuel oil, or any product taxable as gasoline under section 4081 or as diesel fuel under section 4041(a)). This tax is scheduled to be reduced to 1½ cents a gallon on October 1, 1979.

or used for highway-related vehicle use. In the case of diesel fuel, no tax is imposed upon the use of diesel in a nonhighway motor vehicle nor in a motorboat, as the tax is imposed only if sold for or used by a "diesel-powered highway vehicle" (sec. 4041(a)). However, for the other special motor fuels, there is a tax of 2 cents a gallon for use by a nonhighway motor vehicle or motorboat (sec. 4041(b)).[2]

Reasons for change

It appeared inequitable to the committee to continue taxing certain special motor fuels used in nonhighway motor vehicles while not taxing diesel fuel used in such nonhighway vehicles. Moreover, the committee believes that such nonhighway use of special motor fuels should not have to bear the user charge, and therefore the committee decided to remove the tax discrimination between nonhighway use of diesel and other special motor fuels.

Explanation of provision

The committee amendment provides for an exemption from the 2 cents-a-gallon retailers excise tax on special motor fuels sold or used for a nonhighway motor vehicle (other than for motorboat or noncommercial aviation use). This is in order to remove the tax distinction between, for example, liquefied petroleum gas (propane) used in an industrial lift truck (which is subject to a tax of 2 cents a gallon) and diesel fuel used in a diesel-powered lift truck (which is not subject to any fuel tax). The exemption is accomplished by providing for a refund or credit (sec. 6427) for tax paid for such nonhighway use of special motor fuels.

The House bill contains no comparable provision.

Effective date

This amendment is effective for the use of certain special fuels for nonhighway motor vehicles as described above on or after July 1, 1976.

Revenue effect

It is estimated that this amendment will involve a small revenue loss.

13. Oil Swaps (sec. 2010 of the bill and part 10 of Schedule 4 of the Tariff Schedules of the United States, 19 U.S.C. 1202, new item 475.12 and new headnote)

Present law

Under present law, all petroleum and petroleum products imported into the United States are subject to import duties, which vary according to grade of the petroleum or type of product.[1]

Canada has announced a policy of gradually reducing its crude oil exports to the United States to zero by the early 1980's, subject to

[2] This 2 cents-a-gallon reduction in the retailers excise tax on special motor fuel does not apply to such fuel for noncommercial aviation use, as there is a separate retailers tax of 7 cents a gallon through June 30, 1980 (sec. 4041(c)).

[1] Between May 11, 1973, and February 1, 1975, a program of import license fees was in effect and regular import duties were suspended. The import license fees were imposed by Presidential Proclamation and administered by the Federal Energy Administration. On August 11, 1975, the Court of Appeals for the District of Columbia held in *Commonwealth of Massachusetts* v. *Simon* that the import license fees imposed by Presidents' Nixon and Ford on imported petroleum and petroleum products were illegal. This decision, also referred to as the *Algonquin* case, is currently pending before the U.S. Supreme Court.

annual reevaluation. United States refiners in several Northern Tier States including Michigan, Minnesota, Montana, North Dakota and Wisconsin, currently rely heavily on crude oil imported from the Northwestern Canadian Provinces. Under Canadian law, all natural resources including petroleum are owned by the provincial governments.

Reasons for change

As a result of the Canadian policy to reduce petroleum exports to the United States, a number of refiners in the Northern Tier States face a cutoff of their crude oil supply because no other oil transportation network is available. Such a cutoff could adversely affect consumers in those States.

Because of the source and structure of both the United States' and Canada's oil distribution systems, it would be more efficient and economical for both countries to make such sales and purchases from each other rather than to switch to exclusively national oil sources and distribution systems.

Negotiations were completed in June, 1975, between the United States and Canada to permit commercial exchange agreements between United States and Canadian refiners. At that time, tho Federal Energy Administration announced that as a result of talks between U.S. and Canadian officials, both governments had agreed to aid in removing governmental obstacles that might prevent the negotiation of company-to-company exchanges of crude oil. In making this announcement, the FEA Administrator stated that oil exchanges between United States and Canadian refiners could contribute to reducing supply and transportation costs, helping consumers in both countries.

Under such agreements, Canadian crude oil would continue to be exported to Northern Tier refiners in excess of amounts which would otherwise be exported under the Canadian phaseout schedule. In return, United States refiners would deliver crude oil to the Canadian companies. Such arrangements would make unnecessary the construction of new and expensive pipelines to serve refiners in the Northern Tier States which are heavily dependent on Canadian crude oil.

Under such arrangements, imposing duties on crude oil imported from Canada would artificially inflate the price of petroleum products to United States consumers in the Northern Tier States. The committee believes that duties on Canadian oil imported pursuant to swap arrangements would interfere with mutually beneficial joint ventures and exchanges, and might seriously injure the Northern Tier States.

In the event that United States and Canadian companies agree to engage in oil swaps. the committee believes that the amount of U.S. imports of oil from Canada which should be exempt from duties should be of the same kind and quality and equal to the amount of Canadian imports of oil from United States refiners.

Explanation of provision

The committee amendment provides for the duty-free treatment of oil imported from Canada under company-to-company oil swap arrangements made pursuant to agreement between the governments of the United States and Canada. The House bill contains no similar provision.

Under the committee amendment, the United States tariff schedules are modified to exempt oil imported from Canada into the United States from the import duties set forth in Schedule 4, part 10 of such schedules, if the oil is imported as part of an oil swap arrangement. The types of petroleum eligible for such swaps are crude petroleum, including reconstituted crude petroleum, and crude shale oil. The quantity of imported Canadian oil exempted from U.S. duties must be equivalent in amount, kind and quantity to the oil which is imported by Canada from United States refiners during the 30-day period preceding the date of entry of the Canadian oil into the United States.

The amount of Canadian oil entering the United States duty-free cannot be offset against any merchandise except the oil exported by United States refiners to Canada. In order for the Canadian oil to qualify for duty-free entry, the oil exported by United States refiners under the swaps must be either domestic United States oil or oil from foreign sources on which United States refiners have already paid the United States import duties.

Effective date

The committee amendment shall apply to taxable years beginning after December 31, 1976.

Revenue effect

This provision is not expected to have any effect on tax receipts.

U. TAX-EXEMPT ORGANIZATIONS

1. Declaratory Judgments as to Tax-Exempt Status as Charitable, etc., Organization (sec. 2101 of the bill and new sec. 7428 of the Code)

Present law

An organization that meets the requirements of section 501(c)(3) of the Code [1] is exempt from tax on its income.[2]

In general, a domestic organization which is exempt under section 501(c)(3) is also eligible to receive deductible charitable contributions (sec. 170(c)(2)).

If such an organization is a private foundation (defined in sec. 509), then it is subject to a series of restrictions on its activities (sec. 4941 *et seq.*), as well as a tax on its investment income (see footnote 2 above). Also, if it is classified as a private foundation (other than an operating foundation (sec. 4942(j)(3)); its status as a charitable contribution donee is in some respects significantly less favorable than if it is not so classified (compare sec. 509(a) with sec. 170(b)(1)).

Although the tax status of an organization generally does not depend on the Internal Revenue Service's position as to the organization, as a practical matter, most organizations hoping to qualify for exempt status find it imperative to obtain a favorable ruling letter from the Service and to be listed in the Service's "blue book" (Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954, Publication 78). An exemption letter and listing in the blue book assure potential donors in advance that contributions to the organization will qualify as charitable deductions under section 170(c)(2). In general, potential donors may rely upon these indicia even though the organization may not in fact be qualified under the statute for this treatment at the time of the gift.[3]

[1] "SEC. 501 EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

"(a) Exemption From Taxation.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * * * * * *

"(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

* * * * * * *

"(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literar, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (ncludng the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."

[2] Such an organization is, nevertheless, subject to tax on its "unrelated business taxable income" (sec. 511 *et seq.*) and, if it is a private foundation, is also subject to tax on its "net investment income" (sec. 4940); however, it is not subject to Federal income tax on its related business income. The tax on private foundatons' investment income is at the rate of 4 percent but would be taxed at the rate of 2 percent, under another section of the committee amendment; by comparison, the rates applicable to taxable corporations are up to 48 percent, and to taxable trusts are up to 70 percent.

[3] See Rev. Proc. 1972-39, 1972-2 C.B. 816, for the Service's position on the extent to which contributors may rely on the listing of an organization in the blue book.

In two cases decided in 1974 (*Bob Jones University* v. *Simon*, 416 U.S. 725, and *Alexander* v. "*Americans United*" *Inc.*, 416 U.S. 752), the Supreme Court held that an organization could not obtain the assistance of the courts to restrain the Internal Revenue Service from withdrawing a favorable ruling letter or withdrawing its listing in the blue book. In effect, this means that a judicial determination as to the organization's status cannot be had by the organization or its contributors, except in the context of a suit to redetermine a tax deficiency or to determine eligibility for a refund of taxes.

By the time the Supreme Court issued its opinions in *Bob Jones* and *Americans United*, both Houses of Congress had already passed versions of what became the Employee Retirement Income Security Act of 1974 (Public Law 93–406). Each House's version of that bill included provisions for declaratory judgments as to the tax-qualified status of employee retirement plans. This ultimately became section 1041 of that Act, which added section 7476 to the Internal Revenue Code.

Under that provision, the Tax Court has been given jurisdiction to hear declaratory judgment suits as to the tax qualifications of an employee retirement plan (pension, profit sharing, stock bonus, etc.), so that the plan's status can be tested without the necessity of the Service issuing a notice of deficiency or a taxpayer suing for a refund of taxes.

Reasons for change

In *Bob Jones University* v. *Simon*, the Supreme Court summarized the problems faced by an organization seeking to establish its charitable tax-exempt status. The Court noted that, as it interpreted present law,

"Congress has imposed an especially harsh regime on § 501(c)(3) organizations threatened with loss of tax-exempt status and with withdrawal of advance assurance of deductibility of contribution. * * * The degree of bureaucratic control that, practically speaking, has been placed in the Service over those in petitioner's position [i.e., the position of Bob Jones University] is susceptible to abuse, regardless of how conscientiously the Service may attempt to carry out its responsibilities. Specific treatment of not-for-profit organizations to allow them to seek preenforcement review may well merit consideration." [4]

The opinion then suggested that this is an appropriate matter for the Congress to consider.[5]

[4] The Court's opinion noted that former Internal Revenue Commissioner Thrower had criticized the present system for resolving such disputes between the Service and the organization.

"This is an extremely unfortunate situation for several reasons. First, it offends my sense of justice for undue delay to be imposed on one who needs a prompt decision. Second, in practical effect it gives a greater finality to IRS decisions than we would want or Congress intended. Third, it inhibits the growth of a body of case law interpretative of the exempt organization provisions that could guide the IRS in its further deliberations." (Thrower, IRS Is Considering Far Reaching Changes in Ruling on Exempt Organizations, 34 Journal of Taxation 168 (1971).)

[5] In a dissenting opinion to *Alexander* v. *"Americans United", Inc.*, the companion case to *Bob Jones University* v. *Simon*, Mr. Justice Blackmun stated that, "where the philanthropic organization is concerned, there appears to be little to circumscribe the almost unfettered power of the Commissioner." This may be very well so long as one subscribes to the particular brand of social policy the Commissioner happens to be advocating at the time (a social policy the merits of which I make no attempt to evaluate), but applications of our tax laws should not operate in so fickle a fashion. Surely, social policy in the first instance is a matter for legislative concern. To the extent these determinations are reposed in the authority of the Internal Revenue Service, they should have the system of checks and balances provided by judicial review *before* an organization that for years has been favored with an exemption ruling is imperiled by an allegedly unconstitutional change of direction on the part of the Service." (Footnote omitted.)

In order to provide an effective appeal from an Internal Revenue Service determination that an organiaztion is not exempt from tax, or is not an eligible donee for charitable contributions, or is a private foundation (an operating foundation or a nonoperating foundation), it has been urged that there be access to the courts through some declaratory judgment procedure.

The same line of reasoning outlined by the Supreme Court in those two cases, and which motivated the Congress to act with regard to employee retirement plans, applies in this case. Accordingly, the committee has agreed to provide in its amendment for a declaratory judgment procedure under which an organization can obtain a judicial determination of its own status[6] as a charitable, etc., organization, its status as an eligible charitable contribution donee, its status as a private foundation, or its status as a private operating foundation. Also, the committee amendment provides assurances regarding contributions made during the litigation period.

In connection with this, and as an aid to proper oversight and to future decision-making in this area, the committee intends that the Internal Revenue Service report annually to the tax-writing committees of the Congress on the Service's activities with regard to organizations exempt under section 501(a), including the following: (1) the number of organizations that applied for recognition of exempt status, (2) the number of organizations whose applications were accepted and the number of organizations whose applications were denied, (3) the number of organizations whose prior favorable ruling letters were revoked, (4) the number of organizations that were audited during the year, and (5) the number of organizations that the Service regards as being exempt. To the extent possible, these statistics should be broken out by type of organization (e.g., public charity, private foundation, social welfare organization, fraternal beneficial association, and veterans organization). In addition, the Service should report the amount of its expenditures for the year, the amount of its requested appropriations for the following 2 years, the amounts appropriated for each of the years, and the amounts authorized to be appropriated under the terms of section 1052 of the Employee Retirement Income Security Act of 1974.

Explanation of provision

In general.—The amendment provides that the Federal district court for the District of Columbia, the United States Court of Claims, and the United States Tax Court are to have jurisdiction in the case of an actual controversy involving a determination (or failure to make a determination) by the Internal Revenue Service with respect to the initial or continuing qualification or classification of an organization as an exempt charitable, etc., organization (sec. 501(c)(3)), as a

[6] The Supreme Court has implicitly held that under certain circumstances suits can be brought by third parties to restrain the Internal Revenue Service from treating an organization as being exempt, *Coit* v. *Green,* 404 U.S. 997 (1971), affirming *Green* v. *Connally*, 330 F. Supp. (D.C., D.C., 1971), a decision by a special 3-judge district court. The committee's amendment does not deal with this matter. This amendment constitutes neither an implied endorsement nor an implied criticism of such "third-party" suits. However, the committee does intend that, with respect to accepting *amicus curiae* briefs and permitting appearances by third parties in declaratory judgment suits under this amendment, the courts should be as generous as they can be, in the light of the need for expeditious decisions in those cases and the general state of the courts' calendars.

qualified charitable contribution donee (sec. 170(c)(2)), as a private foundation (sec. 509), or as a private operating foundation (sec. 4942(j)(3)). A suit under this provision can be brought only by the organization whose qualification or status is at issue.

The House bill is the same as the committee amendment, except for the courts which are to have jurisdiction (U.S. Tax Court and all Federal district courts, under the House bill) and the effective date.

The courts are to have jurisdiction to make a declaration with respect to the status of the organization and any such declaration is to have the force and effect of a decision or final judgment and is to be reviewable as such.

The court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new argument which the Service may wish to introduce at the time of the trial. The burden-of-proof rules are to be developed by the courts under their rule-making powers. Insofar as is practical, those rules should conform to the rules that the Tax Court develops with regard to declaratory judgment suits as to retirement plans, under section 7476 of the Code. (See *e.g.*, title XXI of the Tax Court's Rules of Practice and Procedure.)

The judgment of the court in a declaratory judgment proceeding is to be binding upon the parties to the case based upon the facts as presented to the court [7] in the case for the year or years involved. This, of course, does not foreclose Service action for later years (within the limits of the legal doctrines of estoppel and *stare decisis*) if the governing law or the organization's operations have changed since the years to which the declaratory judgment applies, or (especially in the case of a new organization) if the organization does not in operation meet the requirements for qualification.

This provision is intended to facilitate relatively prompt judicial review of the specified types of exempt organization issues; it is not intended to supplant the normal avenues of judicial review (redetermination of a deficiency or suit for refund of taxes) where those normal procedures could be expected to provide opportunities for prompt determinations. Consequently, it is expected that the courts will not entertain a declaratory judgment suit with regard to a period for which a notice of deficiency has already been issued, except upon a showing by the organization that the declaratory judgment route is likely to substantially reduce the time necessary to attain a final judicial review of the Service's determination. Also, it is expected that in general a court which has accepted pleadings in a declaratory judgment proceeding will yield to a court which has accepted pleadings in a redetermination of deficiency or a tax refund suit, unless the proceedings in the declaratory judgment suit are so far along that it would facilitate interests of prompt justice for the latter court to yield to the former. The committee's decisions are not to be permitted to create conflicting determinations on the parts of different trial courts with regard to any of the questions that may be determined in a declaratory

[7] In many cases, this would be essentially the administrative record before the Internal Revenue Service; see, e.g., paragraphs (5) and (6) of the prefatory note to title XXI of the Tax Court's Rules of Practice and Procedure.

judgment suit; nor are the committee's decisions to operate so as to require duplication of effort on the part of parties, witnesses, or courts.

Contributions made during the litigation period.—As is the case regarding retirement plans (under sec. 7476) the courts are to have jurisdiction to determine whether the Service has correctly concluded that a previously exempt organization has lost its charitable donee status because of changes in operation, changes in the governing law, changes in the governing instrument, etc. In order to reduce the likelihood of the litigation "drying up" the resources of an organization's support (especially if that organization depends primarily on current contributions from the general public), the committee has provided that, under specified circumstances, contributions made during the litigation period may be deductible even though the court ultimately determines that the organization had lost its status as an eligible charitable donee under section 170(c)(2) of the Code.

This protection is to apply only where the organization had previously been declared to be an eligible donee, the Service has published a notice of the revocation of its advance assurance of deductibility of contributions, and the organization has initiated its proceeding before the 91st day after the Service mailed its adverse determination to the organization. The "publication" requirement is satisfied if the Internal Revenue Service has made a public announcement, such as by issuing a press release or by printing the notice in the Internal Revenue Bulletin.

Sometimes, the first notice to the public consists of a notice of suspension of advance assurance of deductibility of contributions to the organization. (See sec. 4 of Rev. Proc. 72-39, 1972-2 CB 818.) In terms of its effect on potential contributors, such a notice is the functional equivalent of a notice of revocation. That is, potential contributors will be reluctant to make contributions to the organization once notice of such a suspension is published. Consequently, for purposes of the provision protecting contributions made during the litigation period, a notice of suspension of advance assurance is to be treated the same as a notice of revocation of advance assurance of deductibility.

If these criteria are met, then contributions made by an individual or by an organization described in section 170(c)(2) which is exempt from tax under section 501(a) to or on behalf of the organization in the period beginning on the date of publication of the notice of revocation and ending on the date on which the court has first determined that the organization is not an eligible donee under section 170(c)(2) are to be treated as having been made to or on behalf of an organization described in section 170(c)(2), for purposes of determining the income tax charitable contribution deduction of the contributor. However, the aggregate of deductions by any individual contributor to be given this protection with regard to contributions to or on behalf of any one organization is not to exceed $1,000 for the entire period.[8] (For these purposes, a husband and wife are to be treated as one contributor.) This benefit is not to apply to any individual who was responsible, in whole or in part, for the actions (or failures to act) on the part of the organization which were the basis for the revocation.

From time to time, the Internal Revenue Service, in announcing its revocations of assurance as to exempt status, has applied this revoca-

[8] Of course, this $1,000 "cap" is not to restrict deductibility of the final decision or judgment is in favor of the chartable, etc., organization.

tion retroactively, to the date of the asserted improper actions or failures to act (sec. 7805(b)). The committee understands that in such cases the retroactive revocation is not applied to those contributors who were innocent of the improper actions or failures to act. The committee intends that the Service continue to follow this course, which is consistent with the rule provided in this amendment.

Exhaustion of administrative remedies required.—For an organization to receive a declaratory judgment under this provision, it must demonstrate to the court that it has exhausted all administrative remedies which are available to it within the Internal Revenue Service. Thus, it must demonstrate that it has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to it, and that it has appealed any adverse determination by a district office to the national office of the Internal Revenue Service or has requested or obtained through the district director technical advice of the national office. To exhaust its administrative remedies, the organization must satisfy all appropriate procedural requirements of the Service. For example, the Service may decline to make a determination if the organization fails to comply with a reasonable request by the Service to supply the necessary information on which to make a determination.

An organization is not to be deemed to have exhausted its administrative remedies in a case where there is a failure by the Internal Revenue Service to make a determination, before the expiration of 270 days after the request for such a determination has been made. Once this 270-day period has elapsed, an organization which has taken all reasonable steps to secure a determination may bring an action even though there has been no notice of determination from the Internal Revenue Service.

Of course, if the Service makes a determination during this 270-day period, then the organization need not wait until the end of the 270-day period to initiate the declaratory judgment proceeding. However, no petition under this provision may be filed more than 90 days after the date on which the Service sends notice to the organization of its determination (including refusals to make determinations) as to the status of the organization.

These effective date provisions have been chosen basically for two purposes: (1) to provide the courts an opportunity to establish any necessary rules and otherwise make administrative preparations for initiation of these new declaratory judgment proceedings, and (2) to assure that "stale" cases are not made the subject of court suits without the organization first giving the Internal Revenue Service an opportunity to reexamine the case. It is not the intention of the committee that the Service is to be permitted to cut off an organizaion's declaratory judgment suit rights by sending the organization its unfavorable determination more than 90 days before this provision would otherwise become effective. It is intended, in such a case, that the Service is to send another determination to the organization at such a time that the organization would have an opportunity to initiate a declaratory judgment court proceeding. For example, if the Service sends an organization an unfavorable determination in July 1976, the Service is to send that organization another determination in, say, December

1976. The December notification is to start the running of the 90-day period for initiating court proceedings. The July notification is to start the litigation period, during which deductibility of contributions is to be protected.

Tax Court commissioners.—In order to provide the Tax Court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the commissioners ("special trial judges") of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court any provide. It is anticipated, for example, that the court may initially provide that all the declaratory judgment cases are to be heard by judges, rather than commissioners. However, if the volume of these cases is large, then the Tax Court may expedite the resolution of these cases by authorizing its commissioners to hear and enter decisions in cases where similar issues have already been heard and decided by the judges of the Court. However, as is the case with regard to Tax Court declaratory judgments in employee retirement plan cases, this example is not intended to be a restriction on the Tax Court's authority with regard to the use of these commissioners in declaratory judgment cases. The flexibility is granted to the Court to assign its commissioners to hear and decide these cases in such a manner as the Court may deem appropriate.

Effective date

These provisions are to apply to pleadings filed with the Federal district court for the District of Columbia, the United States Court of Claims, or the Tax Court more than 6 months after the date of enactment, but only with respect to Service determination (or requests by the organizations for Service determinations) made after January 1, 1976.

Revenue effect

These provisions are not expected to have any revenue effect.

2. Modification of Transitional Rule for Sales of Property by Private Foundations (sec. 2102 of the bill and sec. 101(l) of the Tax Reform Act of 1969)

Present law

The Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 to impose taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions covered by these taxes on "self-dealing" are the sale, exchange, or leasing of property (sec. 4941). In order to avoid unnecessary disruption of existing arrangements, however, the Act provided transitional rules permitting the continuation, without violation of the self-dealing rules of any existing lease (in effect on October 9, 1969) between a foundation and a disqualified person until 1979, so long as the lease remains at least as favorable to the private foundation as it would have been under an arm's-length transaction between unrelated parties. However, for taxable years beginning after the end of 1979, the leasing arrangements must be terminated (sec. 101(l)(2)(C) of the 1969 Act).

Another transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person, if the sales price equals or exceeds the fair market value of the property being sold. However, this rule applies only to business holdings, and not to passive investments, including passive leases (sec. 101(l)(2)(B) of the Act.

Reasons for change

Cases have been brought to the committee's attention in which a private foundation is leasing to a disqualified person property of a nature which is peculiarly suited to the use of that person. In these cases, the value of the property to the disqualified person is greater than that to any other person. Since under present law such a leasing arrangement must be terminated not later than the end of the last taxable year beginning in 1979, and the property cannot be sold to the disqualified person by the private foundation, the foundation probably would be put in the position of being forced to dispose of its property to unrelated persons for less than the value of that property to disqualified persons.

This particular combination of circumstances regarding the sale of leased property was not brought to the attention of Congress when it was considering the Tax Reform Act of 1969. In effect, the sale-of-leased-property situation happens to fall between the above-noted existing transitional rules. It appears likely that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation. Accordingly, the committee amendment minimizes this hardship by the addition of a new transitional rule.

Explanation of provision

The committee amendment revises the transitional rules applicable to the private foundation provisions of the Tax Reform Act of 1969 by adding a new transitional rule to deal with the sale of property by a private foundation to a disqualified person. Under this rule, a private foundation may sell, exchange, or otherwise dispose of property (other than by lease) to a disqualified person if, at the time of the disposition, the foundation is leasing substantially all of that property under a lease subject to the 1979 lease transitional rule described above, and the foundation receives in return an amount which equals or exceeds the fair market value of the property. In computing the fair market value of the property, no diminution of that value is to result from the fact that the property is subject to any lease to disqualified persons.

The fair market value of the property is to be determined either at the time of its disposition, or at the time (after June 30, 1976) that a contract is executed for disposition of the property. The contractual valuation date permits the foundation and the purchaser to have a fixed price in their agreement even though some time may elapse and the value of the property changes between the contract and the actual settlement date.

There is no comparable provision in the House bill.

Effective date

This provision applies to dispositions occurring before January 1, 1978, and after the date of the bill's enactment, in taxable years ending after the date of the bill's enactment.

Revenue estimate

This provision is not expected to have any revenue effect.

3. Private Foundation Set-Asides (sec. 2103 of the bill and sec. 4942 of the Code)

Present law

Under present law, every private foundation (other than an operating foundation (sec. 4942(a)(1)) must make "qualifying distributions" (sec. 4942(g)) of its "distributable amount" [1] for each year.

If a foundation fails to distribute at least the minimum required amount for a given year, the foundation is subject to a tax of 15 percent of the shortfall. This tax applies for each year that the shortfall remains to be distributed. An additional tax of 100 percent applies if the shortfall has not been distributed by the 90th day after the Internal Revenue Service has mailed to the foundation a notice of deficiency with respect to the 15-percent tax.

An Amount set aside to be paid out for a specific project may be treated as a "qualifying distribution" for the year of the set-aside (under sec 4942(g)(2)); but only if the set-aside is approved in advance by the Internal Revenue Service. To obtain such approval, the foundation must establish both that the amounts set aside will be paid for the specific project within 5 years,[2] and that the project is one which can better be accomplished by that set-aside than by the immediate payment of funds. If the Internal Revenue Service does not give timely approval of a set-aside, then the set-aside does not constitute a qualifying distribution.

Reasons for change

In some cases, the Internal Revenue Service has been reluctant to approve set-asides that are repeatedly used by a private foundation in making grants, even though the purpose for not paying the grant all at once is to allow the foundation to ensure that the funds are being properly spent. However, foundations which had similar grant programs in effect before the 1969 Act generally have not had to obtain prior approval for programs to replace them because the amounts actually distributed under such foundations' other pre-1969 Act programs still in effect and the replacement programs have been sufficient by themselves to meet the minimum payout requirements.

The committee believes that the policy behind the 1969 provisions for set-asides is sound. However, in certain limited circumstances, some temporary relaxation of the private foundation payout rules, as they relate to set-asides, is desirable.

When a new foundation is established, or when an existing foundation's assets are significantly increased because of a contribution,[3] the committee believes that the payout rules should permit such a foundation to establish set-aside programs for projects which are designed to run several years and which require foundation moni-

[1] The present law's definition of "distributable amount" is modified by section 1004 of the bill. (This is described below in *4. Reduction in Mandatory Payout Rate for Private Foundations.*)

[2] The statute permits the Service to extend the payout period "For good cause shown * * *."

[3] In one case that has been brought to the committee's attention, receipt of a bequest caused a foundation's assets to grow from about $100 million to about $1 billion.

toring. As a result of the present set-aside rules, new foundations and some existing ones whose assets are suddenly and significantly increased may be subject to penalties for failure to fulfill payout requirements, if their new set-aside programs do not receive timely, advance service approval. The rules thus deter such foundations from instituting the type of long-term supervised projects conducted by many major foundations and otherwise generally favored by the Internal Revenue Code provisions on private foundations.

Explanation of provision

The committee amendment modifies the set-aside rules for private foundations to permit a foundation to treat as a current charitable expenditure under temporary, relaxed set-aside rules, an amount set aside to be paid out over the next five years. However, the foundation must continue to comply with the ordinary charitable expenditure requirements. The House bill contains no corresponding provision.

Under the committee amendment, foundations would be permitted to set aside for subsequent payment amounts which might otherwise be required to be paid out immediately in order to avoid the penalty tax. By permitting a foundation to make set-asides in certain limited circumstances without obtaining prior Service approval, the amendment alleviates a situation which was unforeseen at the time of the 1969 legislation, that is, the case of a new foundation or certain existing foundations whose assets are suddenly multiplied many times over, which finds it is impossible, as a result of the Service's inaction, to meet the payout requirements in its early years if it uses the set-aside, because each set-aside grant must be specifically approved in advance by the Internal Revenue Service.

The private foundations which are expected to receive significant help from the special set-aside rules in this amendment are new foundations created after 1971 and existing foundations which complete a qualifying five-year set-aside project in 1976.

The amendment continues present law in requiring, for a set-aside, that the private foundation establish to the satisfaction of the Internal Revenue Service (1) that the amount will be paid for the specific project within 5 years and (2) that the project is one which can be better accomplished by that set-aside than by immediate payment of funds. However, the amendment provides an alternative to the second of the above requirements. Under this alternative, the set-aside is to be allowed if the foundation meets the first of the above requirements and also satisfies the following standards:

First, the set-aside must be for a project which will not be completed before the end of the year in which the set-aside is made.

Second, the private foundation must disburse for charitable purposes in each taxable year beginning after December 31, 1975 (or, if later, after the end of the fourth taxable year following the year in which the foundation was created[4]), not less than the foundation's

[4] A private foundation is not to be permitted to come under the rules of this provision unless it qualifies to do so at its first opportunity. For example, if a private foundation that is now in existence were in 1985 to conclude that it wishes to come under the rules of this provision for automatic set-asides, it is not to then be permitted to transfer some or all of its assets to a new private foundation and then have the new private foundation seek to comply with the rules. The "new" private foundation would be regarded, for these purposes. as having been created not later than the time the transferor foundation was created. See, for example, the provisions of Treasury Regulations § 1.507–3(a).

distributable amount. (See footnote 1, above). For this purpose, only actual distributions (cash or its equivalent) that are made in the taxable year are to be taken into account. However, for this purpose all actual distributions are to be taken into account, even though they may be distributions of amounts that previously were given set-aside treatment.

The third requirement is that during the four taxable years immediately preceding the foundation's first taxable year beginning after December 31, 1975 (or, if later, the first four taxable years after the year of the foundation's creation), the foundation must actually distribute for charitable, etc., purposes an aggregate amount not less than the sum of the following:

80 percent of the first preceding taxable year's distributable amount, plus

60 percent of the second preceding taxable year's distributable amount, plus

40 percent of the third preceding taxable year's distributable amount, plus

20 percent of the fourth preceding taxable year's distributable amount.

As under the second requirement, all actual distributions made during the four-year period, and no others, are to be taken into account. However, in this case only the aggregate amount is relevant; it is not necessary, for example, that the distributions be matched to the distributable amounts for each separate year of the four-year period.

Fourth, if a private foundation fails in any taxable year to disburse the required amounts of cash or its equivalent and if (1) the failure was not willful and was due to reasonable cause, and (2) the foundation distributes an amount equal to that which it failed to distribute during the taxable year within the initial correction period provided by statute (generally, 90 days after the Service has sent a notice of deficiency to the foundation, sec. 4942(j)(2)), then that distribution is to be treated (for purposes of this special set-aside rule) as though it had been made in the year in which it originally should have been made. This delayed distribution enables the foundation to continue to use this special set-aside rule. However, if this short fall in cash distributions also results in a failure to meet the regular distribution requirements of the law, then the delayed distribution does not enable the foundation to avoid the 15-percent excise described above, under present law (unless the foundation also meets the technical requirements of sec. 4942(a)(2) of present law).

The fifth standard in the committee amendment in effect gives the foundation a 5-year carryover of any excess disbursements it may make in any taxable year beginning after December 31, 1975. As is the case under the second, third, and fourth standards, only actual distributions made during the taxable year are to be taken into account for purposes of this carryover.

Effective date

The amendment applies to taxable years beginning on or after January 1, 1975.

Revenue effect

This provision is not expected to have any effect on the revenues.

4. Reduction in Mandatory Payout Rate for Private Foundations (sec. 2104 of the bill and sec. 4942 of the Code)

Present law

Under present law (sec. 4942), each private foundation [1] must distribute currently for charitable, etc., purposes, the greater of all its income or a nannually determined variable percentage of its average investment assets (some times referred to as "noncharitable assets"). Graduated sanctions are imposed in the event of failure to distribute the required amount. For taxable years beginning in 1976, the applicable percentage is 6.75 percent. This percentage is determined annually by the Treasury Department, pursuant to statutory authorization, on the basis of changes in money rates and investment yields, taking into account a standard of a 6-percent foundation payout rate for 1969 and comparing money rates and investment yields for 1969 with those for the immediately preceding year.

The minimum distribution requirement generally must be met for a year by making the required amount of charitable distributions in that year or in the following year.

Failure to comply with the minimum payout requirements results in sanctions against the foundation. The first level of sanction is a tax of 15 percent of the amount that should have been, but was not, paid out. This tax is imposed for each year until the private foundation is notified of its obligation or until the foundation itself corrects its earlier failure by making the necessary payouts. However, to the extent the failure to meet the minimum payout requirement results from an incorrect valuation of the foundation's relevant assets and this incorrect valuation is not willful but is due to reasonable cause, then the foundation can avoid the first-level tax by promptly making additional distributions.

Within 90 days after notification by the Internal Revenue Service the foundation must correct its failure to make the appropriate charitable distributions. This 90-day period may be extended. If the necessary distributions are not made within the appropriate period the second level of sanctions is imposed—a tax of 100 percent of the amount required to be paid out. (If an organization persistently violates the payout rules, a third-level sanction may be imposed, under which the foundation returns to the Treasury all the income, estate, and gift tax benefits received by the foundation on any of its substantial contributors (sec. 507).

Reasons for change

The Tax Reform Act of 1969, as reported by the House Committee on Ways and Means, as passed by the House, and as reported by the Senate Committee on Finance, provided for an initial applicable percentage of 5 percent. This figure was raised to 6 percent by a Senate floor amendment and this was agreed to in the legislation which was finally enacted.

The committee has become convinced that its original judgment as to the appropriate applicable percentage, based upon the economic

[1] Different rules are provided under existing law for private foundations which are operating foundations. The changes made by this provision affect private operating foundations only in one respect. This is discussed subsequently.

conditions of 1969, was correct and that the higher rate provided by the Senate floor amendment may well have damaging effects on the continuing viability of many foundations. The use of 1969 money rates and investment yields for adjusting the annual rate now appears too limited a base for an economically valid income rate projection. In addition, changing the rate annually creates significant uncertainty for foundation managers in planning their grant-making programs.

Explanation of provision

The committee amendment reduces the mandatory annual payout percentage applicable to private foundations to 5 percent and eliminates the authority of the Treasury Department to change that rate from year to year. The House bill contains no similar provision.

Private operating foundations (sec. 4942(j)(3)) are affected by the amendment only in that the amendment reduces the minimum payout requirement of a private operating foundation which qualifies as such under the so-called "endowment alternative" (sec. 4942(j)(3)(B)(ii)). To qualify under this alternative an operating foundation must have an endowment[2] which, assuming a rate of return which is two-thirds of the minimum payout rate, is no more than adequate to meet its current operating expenses. The effect of this amendment is to reduce the endowment alternative minimum payout rate to 3⅓ percent (two-thirds of 5 percent).

Effective date

This amendment applies to taxable years beginning after December 31, 1975.

Revenue effect

This amendment is not expected to have any effect on the revenues.

5. Reduction of Private Foundation Excise Tax Based on Investment Income (sec. 2105 of the bill and secs. 4940 and 4948 of the Code)

Present law

The Tax Reform Act of 1969 imposed a 4-percent excise tax upon the net investment income of private foundations (sec. 4940)[1].

Reasons for change

At the time of the Tax Reform Act of 1969, the committee concluded that it was appropriate to impose a tax on private foundations in the nature of an audit fee, to cover the cost of the Internal Revenue Service's administration of the tax laws pertaining to exempt organizations. The committee also concluded that private foundations should not be required to pay taxes at such a level as to be contributing to the general revenues. In other words, in the committee's view, the basic private foundations tax was to partake of the character of a user charge, with the foundations suffering the burden of paying the user charge for the entire exempt organization community (other than pension, etc., plans).

[2] Plus any other assets not devoted directly to the active conduct of the activities for which the organization is organized.

[1] Section 4948 imposes a 4-percent excise tax upon the gross investment income derived from U.S. sources by foreign private foundations.

On October 4, 1974, the committee's Subcommitte on Foundations issued a report which dealt with the tax imposed on private foundations investment income (Cong. Record, October 4, 1974, pp. S18313–S18318). The subcommittee noted that the tax reduces dollar-for-dollar the amount that private foundations must distribute annually for charitable purposes. After extensively reviewing the legislative history of the section 4940 tax, its effect on private foundations, and the relationship between the revenue generated by the tax and the costs of supervising private foundations and other exempt organizations, the subcommittee recommended that the rate of tax imposed by section 4940 be reduced from 4 percent to 2 percent.

Revenues and the costs of supervision for fiscal years 1971 to 1975 are summarized in the following tabulation:

Fiscal year ending June 30,	Revenues from sec. 4940 Tax	Cost of supervision to Internal Revenue Service	
		Private foundations only	All exempt organizations
1971	$24,589,000	$8,600,000	$15,400,000
1972	56,045,000	12,900,000	19,300,000
1973	76,617,000	12,300,000	18,600,000
1974	68,802,000	13,300,000	23,000,000
1975	63,828,000	7,500,000	24,200,000

The table reveals that the revenues received by the Government under the section 4940 tax are at least double the costs to the Internal Revenue Service of supervising all exempt organizations.

In light of the experience with the tax and the recommendations of the Subcommittee on Foundations, the committee believes that it is appropriate at this time to reduce the rate of tax from 4 percent to 2 percent. In taking this action at this time, the committee does not intend to preclude future periodic reexaminations of the relationship between the revenues raised by this tax and the cost to the Government of administering the tax laws pertaining to private foundations and other exempt organizations.

The committee also is concerned that the Internal Revenue Service devote adequate resources to the administration of those provisions of the law. The tax was instituted in the Tax Reform Act of 1969 in order to assure the availability of such resources. The Employee Retirement Income Security Act of 1974 established a separate office in the Internal Revenue Service to effectively deal with this area and made a permanent authorization of appropriations to further assure the availability of sufficient resources to administer these provisions.

The committee expects and intends that the Internal Revenue Service report annually to the tax-writing committees on the extent to which audits are conducted as to the tax liabilities of exempt organizations, the extent to which examinations are made as to the continued qualification of such organizations for their respective exempt statuses, the extent to which Service personnel are given initial and refresher instruction in the relevant portions of the law and administrative procedures, the extent to which the Service cooperates with and receives cooperation from State officials with regard to supervision of charities and other tax-exempt organizations, the costs of maintaining such programs at levels which would produce proper compliance with the laws, the amounts requested by the Executive Branch for the maintenance of those programs, and the reasons for any difference between the needed funds and the requested amounts. Also, the Internal Revenue Service is to notify the taxwriting committees of any administrative problems that the experienced in the course of its enforcement of the internal revenue laws with respect to exempt organizations.

Explanation of provision

The committee amendment reduces the rate of tax imposed under section 4940 on the net investment income of private foundations from 4 percent to 2 percent. The same change is made with respect to the tax on U.S.-source income of foreign private foundations (sec. 4948). The House bill has no comparable provision.

Effective date

The committee amendment applies to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this will reduce budget receipts by $35 million in fiscal year 1978 and $38 million in fiscal year 1981.

6. Extension of Time To Conform Charitable Remainder Trusts for Estate Tax Purposes (sec. 2106 of the bill and sec. 2055(e)(3) of the Code)

Present law

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

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969, (which did not come within the statutory exceptions) to qualify for an income, estate or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the government instrument had to be amended was further extended by the Internal Revenue Service.[1] On

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

August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72–395 which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under section 664.

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

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

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

Reasons for change

Despite the additional period provided by the 1974 amendment, it has come to the attention of the committee that there are many wills becoming effective which provide a charitable remainder which still do not meet the requirements for qualifications under section 664 for a charitable remainder annuity trust or unitrust. Moreover, the committee was informed that there are also a number of trusts and wills which were drafted after September 21, 1974, which do not comply with the new rules for the allowance of a charitable deduction for estate tax purposes.

The committee believes it is appropriate to provide an additional 2-year extension to permit wills establishing charitable remainder trusts to be amended to comply with the 1969 Act rules for a charitable remainder for estate tax purposes because the policy of these rules is furthered when such trusts are amended to meet these rules. In addition, failure to meet these rules results in additional estate taxes that often are borne substantially by charity.

While your committee believes that an additional extension of two years is appropriate at this time under the circumstances, the committee believes that this should be the last extension permitted by Congress. By the end of this extension, there will have been eight years since the general effective date of the new requirements for deduction under section 2055(e) of the Code. The committee believes that such an eight-year period should be more than enough time for taxpayers and their lawyers to learn the new rules and to implement them into their estate plans.

Also, the committee intends that the Internal Revenue Service make every effort to publicize to taxpayers' attorneys, trust companies, etc., the requirements of the 1969 Act with respect to charitable remainder trusts. The committee solicits the assistance of commercial tax services in similarly publicizing these requirements.

Explanation of bill

The committee amendment extends to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The committee amendment also extends the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977. Under the committee amendment, if the governing instrument is amended by December 31, 1977, to conform to the requirements of a charitable remainder annuity or unitrust or pooled income fund, an estate tax deduction will be allowed for the charitable interest which passed in trust from the decedent even though a deduction originally was not allowed for this interest because the trust failed to qualify as a charitable remainder trust at the time of the decedent's death. This applies to trusts created after July 31, 1969. For these purposes, a trust which first became irrevocable, in whole or in part, after that date is treated as having been created after that date.

There is no corresponding provision in the House bill.

Effective date

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

Revenue effect

It is estimated that this provision will decrease budget receipts by $5 million during fiscal year 1977 and 1978.

7. Income From Fairs, Expositions, and Trade Shows (sec. 2107 of the bill and sec. 513 of the Code)

Present law

Under present law, the unrelated business income tax applies to income from the conduct by an exempt organization of an unrelated trade or business. The term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income derived from such trade or business) to the exercise of its exempt purpose. The term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or services. The law further provides that, for the purpose of defining the trade or business activity, the activity is not to lose its identity as a trade or business merely because it is carried on within a larger aggregate or similar activities or within a large complex of other endeavors which may (or may not) be related to the exempt purposes of the organization.

One major purpose of this provision is to make certain that an exempt organization does not commercially exploit its exempt status for the purpose of unfairly competing with taxpaying organizations. An example of such activity specifically cited in the law is the carrying of advertising in a journal published by an exempt organization.

Reasons or change

It has come to the committee's attention that, in two instances, the Internal Revenue Service has ruled that activities which are not conducted in competition with commercial activities of taxpaying organizations are nevertheless considered to be unrelated trade or business activities which are subject to the unrelated business income tax. In one case (Rev. Rul. 68-505, 1968-2 C.B. 248), the Service ruled that an exempt county fair association which conducts a horse racing meet with parimutuel betting is carrying on an unrelated trade or business subject to the unrelated business income tax. In another case the Service has held, in a series of revenue rulings (TIR-1409, 1975-2 C.B. 220-226), that income that an exempt business league receives at its convention trade show from renting display space may constitute unrelated business taxable income if selling by the exhibitor is permitted or tolerated at the show.

The committee does not believe that the activities dealt with in those rulings are generally unrelated to the exempt purposes of the organizations that conduct them. It is customary for tax-exempt organizations to provide entertainment, incuuding horse racing, at fairs and expositions in order to attract the public to the educational exhibits on display. In addition, trade associations use trade shows as a means of promoting and stimulating an interest in, and demand for, their industries' products in general. They are also able to educate their members regarding new developments and techniques which are available to the trade.

In neither case are the exempt organizations exploiting their exempt status in order to compete unfairly with taxpaying organizations. Generally, horse racing dates are controlled by state authorities and are made available on a state-wide basis to only one organization for any one period. Trade shows are generally conducted only by trade associations and not by taxpaying entities.

Explanation of provisions

In the case of fairs and expositions, the committee's amendment applies to an organization which is exempt under section 501(c) (3), (4) or (5) of the Code (charitable, social welfare, or agricultural) and which operates a qualified public entertainment activity that meets one of the following conditions:

(1) the public entertainment activity is conducted in conjunction with a public international, national, State, regional, or local fair or exposition;

(2) the activity is conducted in accordance with State law which permits that activity to be conducted only by that type of exempt organization or by a governmental entity; or

(3) the activity is conducted in accordance with State law which allows that activity to be conducted for not more than 20 days in any year and which permits the organization to pay a lower percentage of the revenue from this activity than the State requires from other organizations.

In order to qualify for this treatment, the organization must regularly conduct, as one of its substantial exempt purposes, a fair or exposition which is both agricultural and educational. Thus, a book fair held by a university does not come within this provision since such a fair is not an agricultural fair or exposition.

In the case of conventions and trade shows the committee's amendment applies to an organization which is exempt under section 501(c) (5) or (6) of the Code (generally, unions or trade associations) and which regularly conducts as one of its exempt purposes a convention or trade show activity which stimulates interest in, and demand for, an industry's products in general. In order to constitute a qualifying convention and trade show activity all the following conditions must be met:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and,

Third, the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

The conducting of qualified public entertainment activities and qualified convention and trade show activities is not to subject the organization to the unrelated business income tax and the conducting of such activities is not to affect the tax-exempt status of the organization.

There is no corresponding provision in the House bill.

Effective dates

This provision applies to taxable years beginning after December 31, 1962, with respect to qualified public entertainment activities and to taxable years beginning after December 31, 1969, with respect to qualified convention and trade show activities.

Revenue effect

It is estimated that the revenue impact of these provisions will be relatively small.

V. AREAS FOR FURTHER STUDY

In several areas the committee has decided that further study is needed before it can recommend specific tax changes.

The committee has instructed the staff of the Joint Committee on Taxation to make a study of ways to simplify the tax law and tax forms. This study is to include the possibility of repealing any or all tax deductions, exclusions and credits, coupled with a reduction in tax rates.

The committee plans to make a comprehensive study of the need for capital by public utilities to determine what the appropriate tax policy should be for that industry.

The committee has also instructed the staff to make a study of the possibility of adjusting the tax system for inflation. There are two types of tax indexing that are to be included in the study. One type of indexing periodically adjusts all fixed dollar amounts in the tax system, such as the $750 personal exemption, to take account of inflation. The second type of indexing redefines the measure of income from capital to take account of the effect of inflation in eroding the purchasing power of a fixed dollar amount of capital.

The committee plans to study the organization and operation of the United States Tax Court.

There is to be a study of the proper investment tax credit for the trucking industry, particularly in comparison to that of the airline and railroad industries.

In connection with its review of the Highway Trust Fund in 1977, the committee plans to consider what uses of gasoline and other motor fuels should be subject to the excise taxes on such fuels. In addition, the committee is to study the application of the highway use tax to various types of motor vehicles.

The committee also plans to study the taxation of the unrelated business income of religious orders, specifically whether the orders should be permitted to deduct amounts which would be fair compensation to their members had they been nonclerical persons.

The committee has directed the staff to study problems regarding the definition of "independent contractors" as contrasted to "employees." The committee strongly urges the Internal Revenue Service not to issue retroactive Revenue Rulings in this area until after completion of the staff study.

VI. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 10612, AS AMENDED

Revenue cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out the committee's amendment to H.R. 10612. The committee estimates that the changes in fiscal year budget receipts made by this bill are those shown in the following table:

[In millions of dollars]

	Fiscal year					
	Transition quarter	1977	1978	1979	1980	1981
Tax reform program:						
Revenue raising provisions	184	2,536	2,819	3,090	3,316	3,612
Revenue reducing provisions	−227	−1,556	−2,899	−3,250	−3,444	−3,875
Total, tax reform program	−43	980	−80	−160	−128	−263
Extension of tax cuts:						
Standard deduction	−719	−4,146	−4,282	−4,495	−4,721	−4,956
Per capita tax credit	−1,675	−7,638	−367			
Earned income credit		−695	−1,335	−1,282	−1,230	−1,181
Total, individuals	−2,394	−12,479	−5,984	−5,777	−5,951	−6,137
Change in corporate tax rates	−262	−1,676	−2,221	−2,406	−2,579	−2,771
10-percent investment credit		−1,300	−3,306	−3,450	−3,617	−3,814
Total, business	−262	−2,976	−5,527	−5,866	−6,196	−5,585
Total, extension of tax cuts	−2,656	−15,455	−11,511	−11,643	−12,147	−12,722
Grand total	−2,699	−14,475	−11,591	−11,803	−12,275	−12,985

The Treasury Department agrees with this statement. Part III of this report contains a more detailed statement of the revenue effect of the bill.

Vote of the committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 10612, as amended by the committee, was ordered reported by a voice vote.

Tax expenditures

With respect to the effects of the bill on tax expenditures during the next five fiscal years, the following statement has been received from the Director of the Congressional Budget Office:

"In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has examined the committee's revenue estimates for all provisions raising or reducing revenues by $50 million or more in any one of the first 5 years after enactment and agree with the methodology used and the dollar estimates resulting therefrom. As to provisions which affect revenues by less than $50 million, no estimate or comparison of the estimates has been made by the Director of the Congressional Budget Office."

VII. 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).