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TAX REFORM ACT OF 1976

SUPPLEMENTAL REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

ADDITIONAL COMMITTEE AMENDMENT

TO

H.R. 10612

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INTRODUCTION

Because of time pressure and the committee's desire to get the Tax Reform Act of 1976, as amended by the Finance Committee, to the Senate floor as soon as possible, the committee reported the bill only with those amendments acted upon by the committee at the time this bill was ordered to be reported. This was to give the staff time to draft the 1,536-page bill and prepare the report. The report (S. Rept. 94–938) included the committee's decisions up until the time it ordered the bill reported. Subsequent to this, the committee agreed to the additional amendment to be offered on the floor; the additional amendment is described in this supplemental report.

This supplemental report is to be treated as if it were a regular committee report with respect to the explanation of the intent of the Finance Committee regarding the amendment.

I. SUMMARY

The summary presented below outlines the principal features of the additional amendments agreed to by the committee subsequent to the time the committee's amendment to the Tax Reform Bill of 1976 (H.R. 10612) was ordered reported.

Estate and Gift Tax Provisions (Title XXII)

1. *Estate tax credit.*—An estate tax credit is provided in lieu of the present estate tax exemption. The amount of the credit will be $30,000 for decedents dying in 1977 (equivalent to an exemption of $131,000) and will increase by $5,000 per year until 1981 when the credit will be $50,000 (equivalent to a $197,000 exemption).

2. *Marital deduction.*—The maximum estate tax marital deduction for property passing from the decedent to his surviving spouse is increased to the greater of $250,000 or one-half of the decedent's adjusted gross estate.

3. *Valuation of certain real property.*—Qualified real property is to be includable in the decedent's gross estate on the basis of its current use rather than on the basis of its highest and best use. Real property that can qualify for this special treatment will include property used for (1) farming, (2) woodland, (3) open pastoral space, or (4) the maintenance of historic values.

4. *Extension of payment time.*—The period for payment of the estate tax attributable to the decedent's interest in a farm or closely-held business is increased from 10 to 15 years. No part of the estate tax is to be payable for the first three years; thereafter, the tax is to be payable in equal installments over the next 12 years. In addition, a special 6-percent interest rate is to apply to the tax attributable to the first $1 million of farm or other closely held business property. A "reasonable cause" standard for the discretionary 10-year extension for the payment of estate tax is to be substituted for the existing "undue hardship" standard.

5. *Generation-skipping transfers.*—A tax is to be imposed in the case of a generation-skipping transfer under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir or upon the termination of an intervening interest in the trust. The tax generally is to be paid out of the proceeds of the trust and is to be substantially equivalent to the estate or gift tax which would have been imposed if the property had actually been transferred outright to each successive generation.

6. *Gift tax treatment of certain annuities.*—The value of a non-employee's interest is to be excluded from the taxable gifts of the surviving spouse to the extent the value of that interest is attributable to the contributions of the employer and to the extent the value arises solely by reason of the spouse's interest in the community income of the employee under the community property laws of the State.

Other Amendments (Title XXIII)

1. *Outdoor advertising displays.*—Taxpayers are to have the election to treat outdoor advertising displays as real property under certain circumstances.

2. *Large cigars.*—The excise tax on large cigars is changed from a bracket system based on the intended retail price to an ad valorem tax of 8½ percent of the wholesale price.

3. *Gain from sales or exchanges between related parties.*—Ordinary income tax treatment is extended to gains from sales of depreciable property between two corporations that are controlled by the same individual and his family. In addition, the amendment makes certain rules of constructive ownership apply in this situation.

4. *Extension of Uniformed Services scholarship exclusion.*—The exclusion from income for amounts received as scholarships under the Armed Forces Health Professions Scholarship Program (or any substantially similar program) is extended to cover the year 1976.

5. *Tax counseling for the elderly.*—Provision is to be made for a volunteer tax counseling program for the elderly.

6. *Tax credit for certain education expenses.*—A tax credit is to be provided for certain expenses relating to higher eduction.

7. *Commission on Value Added Taxation.*—A 20-member National Commission on Value Added Taxation is to be established to make a study of the value added tax and its effects on savings, consumption, capital formation, international trade policy, and general government finance, as well as its potential use as an alternative source of financing the social security system. A report is to be made to the President and to the Congress by December 31, 1977.

8. *Industrial development bonds for certain hospital construction.*—An exception to the small issues limitation on industrial development bonds is to be provided for the construction of private hospitals where the bond issue does not exceed $20 million and the hospital has been certified as necessary in their communities by the appropriate State health agency.

9. *Group legal services plans.*—An exclusion from an employee's gross income is provided for amounts contributed or service or reimbursements provided by an employer under a qualified group legal services plan for the benefit of the employee, his spouse, or his dependents.

10. *Exchange funds.*—Generally, amounts contributed to partnership exchange funds (so-called "swap funds"), as well as the merger of certain investment companies, are to be treated as taxable transactions where a taxpayer's principal interest is to diversify his investments without current payment of tax.

11. *Subchapter S corporation distributions.*—An amendment was adopted modifying the rules pertaining to the number of shareholders of a subchapter S corporation.

International Trade Commission (Title XXIV)

The voting procedures of The International Trade Commission in import relief cases are changed to insure that the Congress will have an opportunity to override import relief decisions of the President under sections 201 and 406 of the Trade Act of 1974. The Commission membership is to be increased from six to seven members, and certain other procedural and organizational changes are to be made with respect to the Commission.

Miscellaneous Amendments (Title XXV)

1. *Disability payments exclusion.*—An exclusion from gross income is provided for disability payments received by U.S. Government employees on account of personal injuries occurring outside of the United States as a result of a terrorist attack.

2. *Changes in treatment of foreign income.*—The foreign tax credits which are to be allowed an additional 2-year carryover under the committee's amendment to H.R. 10612, as reported, are to be applied on a first-in-first-out (FIFO) basis.

Individuals are to have the option of claiming a foreign tax credit on income earned abroad in lieu of the $20,000 (or $25,000) exclusion from income.

In addition, any loss from a foreign subsidiary is not to be subject to foreign loss recapture to the extent that it is attributable to a deficit in earnings and profits as of December 31, 1976, where the loss is sustained prior to January 1, 1979.

Further, foreign source income derived by a possessions corporation is entitled to the possessions tax credit if earned before October 1, 1976, without regard to the requirement of its being earned in the possession in which the trade or business providing the funds is being conducted.

3. *Treatment of certain individuals employed in fishing as self-employed.*—Crewmen on boats engaged in taking fish (or other forms of aquatic animal life) with an operating crew of fewer than 10 are to be treated as self-employed for Federal tax purposes in certain instances. (This modifies an earlier committee provision pertaining to boat crewmen.)

4. *Energy-related provisions.*—A special credit for wind-related residential energy equipment is provided where it is installed to generate electricity to heat or cool residences or to provide hot water for them.

A special investment credit is provided for wind-related energy equipment installed for use in the trade or business of producing the electricity or the generation of electricity for use in a trade or business.

5. *Sliding-scale inclusion ratio for capital gains.*—The 50-percent capital gains exclusion for capital gains is increased for assets held more than 5 years by one percentage point for each year an asset is held in excess of 5 years, but with a minimum inclusion of 30 percent (after 25 years).

6. *Pensions, ESOP's and related items.*—The Pension Benefit Guaranty Corporation is to be exempt from all Federal taxation except taxes imposed under the Federal Insurance Contributions Act (social security taxes) and the Federal Unemployment Tax Act (unemployment taxes).

In addition, unincorporated businesses are to be allowed to make contributions to tax-qualified pension plans (an H.R. 10 plan) on behalf of an owner of a business, under the usual H.R. 10 rules for plans funded with annuity contracts, without disqualifying the plan under the overall limitations on benefits and contributions under tax-qualified plans.

With respect to Employee Stock Ownership Plans (ESOP's), two provisions previously agreed to by the committee are to be deleted. These (1) would require ESOP's funded with investment tax credits to provide for broader employee participation, and (2) would end the treatment of ESOP's as employee pension or welfare plans under Federal law (other than tax law).

In addition, an amendment was adopted permitting employees to elect out of an ESOP funded with investment tax credits.

7. *Tax-exempt organizations and charitable contributions.*—Tax-exempt hospitals are to be permitted to provide laundry services to small tax-exempt hospitals for a fee without the income from these services being subject to the unrelated business income tax.

Laundry and clinical services are to be tax-exempt when cooperatively operated by a service organization created by tax-exempt hospitals.

United States Government publications received by taxpayers without charge or at a reduced price are no longer treated as capital assets and as a result a charitable contributions deduction will no longer be available when they are contributed to charity.

Corporations (other than a subchapter S corporation) are to be allowed a deduction for up to one-half of the appreciation on certain types of ordinary income property contributed to a public charity or private operating foundation for use in carrying on its exempt purpose.

Public charities (other than a church, an organization affiliated with a church, or certain support organizations), are to be permitted to elect to have their lobbying activities measured by an "expenditures" test rather than the "substantiality" test of present law.

In taxing the income of an exempt organization, to the extent the income is derived from "debt-financed property", the term "acquisition indebtedness" is not to include taxes and special assessments imposed by State or local governmental units until those taxes or special assessments become due and payable and the organization has had an opportunity to pay them in accordance with State law.

The expiration date of a private foundation transitional rule contained in the Tax Reform Act of 1969 is extended to January 1, 1977. In general, this extension applies to a rule which exempts from the self-dealing rules, certain sales, exchanges, or other dispositions of certain "nonexcess" business holdings by a private foundation to a disqualified person so long as the private foundation receives at least fair market value.

The minimum distribution requirement for private operating foundations is generally reduced to 3 percent. Also imputed interest income on pre-1970 installment payments is excluded from the distribution requirements applicable to private foundations. Finally, this amendment exempts libraries and museums, where they elect this general 5 percent payout rule from the net tax on investment income applicable to private foundations.

8. *Low-income allowance.*—An amendment was adopted increasing the low-income allowance to $1,850 for single returns and $2,400 for joint returns for the calendar year 1977, with the increase to be reflected in lower withholding during the last 6 months of 1977. For 1978 and future years, the low-income allowance is to be $2,000 for single returns and $2,700 for joint returns. (Without this change the low income allowance would be $1,700 for single returns and $2,100 for joint returns.)

9. *Equipment leasing—transitional rule for "at risk" limitation.*—A transitional rule to the committee's "at risk" provision was provided for equipment leasing so that this rule will not apply to losses incurred under a lease in effect on December 31, 1975.

10. *Architectural, etc., barriers to handicapped persons—to include the deaf and blind.*—A clarification of the previous committee provisions provides that the current deduction for the removal of barriers to handicapped and elderly persons is to include the removal of barriers provided for blind and deaf people within the definition of handicapped persons.

II. REVENUE ESTIMATES

As indicated in Table 1, the revenue raising provisions of the committee floor amendments to H.R. 10612 are estimated to generate less than $5 million in fiscal years 1977 and 1978, $5 million in 1979, $8 million in 1980, and $13 million in 1981. The primary source of this increase in receipts is the "exchange funds" provision.

The liberalized standard deduction provision, the chief revenue reducing floor amendment, is estimated to result in a decrease in receipts of $597 million in fiscal year 1977, $2.9 billion in 1978, $3.2 billion in 1979, $3.4 billion in 1980, and $3.6 billion in 1981. Revision of the estate and gift taxes is estimated to result in a decrease in receipts of $1 billion in fiscal year 1978, $1.4 billion in 1979, $1.7 billion in 1980, and $2 billion in 1981. Other revenue reducing floor amendments are estimated to result in a decrease in receipts of $54 million in fiscal year 1977, $525 million in 1978, $1.5 billion in 1979, $1.8 billion in 1980, and $2.1 billion in 1981. The total estimated effect of all the revenue reducing provisions combined is a reduction in receipts of $651 million in fiscal year 1977, $4.5 billion in 1978, $6.1 billion in 1979, $6.9 billion in 1980, and $7.6 billion in 1981.

Table 2 shows the impact on tax receipts of each of the committee floor amendments in the transition quarter and in each of the fiscal years 1977 through 1981. As indicated in this table, the contributors to revenue raising are the "exchange funds" provision and (for one fiscal year, 1981) the equipment leasing "at risk" provision. The principal categories of revenue reducing provisions are the liberalized minimum standard deduction, $597 million for fiscal year 1977, $2.9 billion for 1978, and $3.6 billion for 1981; the revised estate and gift taxes, $1 billion for fiscal year 1978 rising to $2 billion by 1981; the liberalized inclusion ratio for capital gains, $719 million for fiscal year 1979, $791 million for 1980, and $870 million for 1981; and the phased-in credit for expenses of postsecondary education, $467 million for fiscal year 1978, $711 million for 1979, and $1.1 billion for 1981. Table 2 also breaks down the net effect of the floor amendments between individuals and corporations. Almost all of the net tax decrease is accounted for by revenue reducing floor amendments affecting individuals.

Table 3 shows at 1975 levels, by adjusted gross income class, the full-year estimated decrease in individual income tax liability resulting from liberalization of the minimum standard deduction. This table shows that 62.1 percent of the $2.7 billion reduction goes to returns with less than $10,000 of adjusted gross income and 35.6 percent goes to returns with between $10,000 and $15,000 of adjusted gross income. This table also indicates that 39.2 million returns show a decrease in tax liability, of which 2.2 million become nontaxable. Also, as indicated in this table, 3.8 million returns are estimated to shift to the standard deduction.

Table 4 shows, for selected tax returns, representing different marital status, different numbers of exemptions, and different levels of adjusted gross income, the tax burden under the standard deduction provision in the bill reported by the Senate Finance Committee and the tax burden under the standard deduction provision in the committee floor amendment.

TABLE 1.—SENATE FINANCE COMMITTEE FLOOR AMENDMENTS TO H.R. 10612 [1]: SUMMARY OF THE EFFECT ON FISCAL YEAR TAX RECEIPTS

[In millions of dollars]

	Fiscal year—					
	TQ	1977	1978	1979	1980	1981
Revenue raising provisions	(2)	(2)	(2)	5	8	
Revenue reducing provisions:						
Liberalized minimum standard deduction		−597	−2,908	−3,245	−3,407	−3,577
Revised estate and gift tax			−1,042	−1,367	−1,688	−2,006
Other revenue reducing provisions	−9	−54	−525	−1,499	−1,792	−2,065
Total, revenue reducing provisions	−9	−651	−4,475	−6,111	−6,887	−7,648
Net total, all provisions	−9	−651	−4,475	−6,106	−6,879	−7,635

[1] Additional amendments agreed to by the committee after the bill was ordered reported. These amendments are to be offered on the floor.
[2] Less than $5,000,000.

TABLE 2.—SENATE FINANCE COMMITTEE FLOOR AMENDMENTS TO H.R. 10612 [1]: ESTIMATED EFFECT ON FISCAL YEAR RECEIPTS

[In millions of dollars]

	Fiscal year—					
	TQ	1977	1978	1979	1980	1981
A. Title XXII—Estate and gift taxes: Phased-in credit in lieu of the exemption; liberalized marital deduction; current use valuation and liberalized deferral in the case of farms, etc.; elimination of the tax advantages of generation skipping; etc.			−1,042	−1,367	−1,688	−2,006
B. Title XXIII—Other amendments:						
1. Outdoor advertising displays						
2. Tax treatment of large cigars		−7	−7	−7	−7	−7
3. Treatment of gain from sales or exchanges between related parties	(2)	(2)	(2)	(2)	(2)	(2)
4. Application of sec. 117 to certain education programs for members of the uniformed services [3]	−2	−3				
5. Tax counseling for the elderly		(2)	(2)	(2)	(2)	(2)
6. Credit for certain expenses incurred in providing education			−467	−711	−926	−1,103
7. Commission on value added taxation						
8. Interest on certain governmental obligations for hospital construction		−1	−3	−7	−9	−14
9. Group legal services plans	−2	−5	−8	−16	−21	−33
10. Exchange funds	(2)	(2)	(2)	5	8	12
11. Distributions by subch. S corporations	(2)	(2)	(2)	(2)	(2)	(2)
Total, title XXIII	−4	−16	−485	−736	−955	−1,145
C. Title XXIV—International Trade Commission						

TABLE 2.—SENATE FINANCE COMMITTEE FLOOR AMENDMENTS TO H.R. 10612[1]: ESTIMATED EFFECT ON FISCAL YEAR RECEIPTS—Continued

[In millions of dollars]

	Fiscal year—					
	TQ	1977	1978	1979	1980	1981
D. Title XXV—Miscellaneous amendments:						
1. Sick pay and military, etc. pension exclusion—injuries resulting from acts of terrorism	(2)	(2)	(2)	(2)	(2)	(2)
2. Changes in treatment of foreign income:						
(a) Ordering of foreign tax credit carryover		−2	−3	−2	−1	−1
(b) Exclusion of income earned abroad	(2)	(2)	(2)	(2)	(2)	(2)
(c) Recapture of foreign losses		(2)	(2)	(2)		
(d) Tax treatment of corporations conducting trade or business in Puerto Rico or possessions of the United States	−2	−b				
3. Treatment of certain individuals employed in fishing as self-employed[4]	(2)	−13	−13	−13	−13	−13
4. Energy related provisions:						
(a) Special credit for wind-related residential energy equipment	(3)	(2)	(2)	(2)	(2)	(2)
(b) Special investment credit for windmills used in the production of electricity	(2)	(2)	(2)	(2)	(2)	(2)
5. Sliding-scale inclusion ratio for capital gains[5]				−719	−791	−870
6. Pensions, ESOP's and related items:						
(a) Taxable status of Pension Benefit Guaranty Corporation						
(b) Level premium annuity contracts held by H.R. 10 plans	(2)	(2)	(2)	(2)	(2)	(2)
(c) Employee stock ownership plans	(2)	(2)	(2)	(2)	(2)	(2)
(d) Election not to participate in an employee stock ownership plan		(2)	(2)	(2)	(2)	(2)
7. Tax-exempt organizations and charitable contributions:						
(a) Unrelated business income from services provided by a tax-exempt hospital to other tax-exempt hospitals	(2)	(2)	(2)	(2)	(2)	(2)
(b) Hospital laundry facilities		(2)	(2)	(2)	(2)	(2)
(c) Donation of government publications	(2)	(2)	(2)	(2)	(2)	(2)
(d) Certain charitable contributions of inventory	−3	−16	−22	−22	−24	−24
(e) Lobbying activities of public charities	(2)	(2)	(2)	(2)	(2)	(2)
(f) Tax liens, etc., not to constitute "acquisition indebtedness"	(2)	(2)	(2)	(2)	(2)	(2)
(g) Extension of private foundation transition rule for sale of business holdings	(2)	(2)				
(h) Private operating foundations; imputed interest	(2)	(2)	(2)	(2)	(2)	(2)
8. Low income allowance		−597	−2,908	−3,245	−3,407	−3,577
9. Equipment leasing—transitional rule for "at risk" limitations	(2)	−1	−2	−2	(2)	1
10. Architectural, etc., barriers to handicapped persons—to include the deaf and blind		(2)	(2)	(2)		
Total, title XXV	−5	−635	−2,948	−4,003	−4,236	−4,484
Total, titles XXII–XXV	−9	−651	−4,475	−6,106	−6,879	−7,635
Revenue raising provisions	(2)	(2)	(2)	5	8	13
Revenue reducing provisions	−9	−651	−4,475	−6,111	−6,887	−7,648
Individuals	−4	−619	−4,440	−6,068	−6,938	−7,589
Corporations	−5	−32	−35	−38	−41	−46

[1] Additional amendments agreed to by the committee after the bill was ordered reported. These amendments are to be offered on the floor.
[2] Less than $5,000,000.
[3] There is also an estimated $2,000,000 decrease in budget receipts for fiscal year 1976 under this provision.
[4] It is estimated that this provision will decrease budget receipts by $65,000,000 in the aggregate over the next 5 fiscal years.
[5] This is the net effect of this provision after deducting from the gross decrease in budget receipts the increase in the Finance Committee minimum tax.

TABLE 3.—ESTIMATED FULL-YEAR DECREASE IN INDIVIDUAL INCOME TAX LIABILITY UNDER THE LIBERALIZED MINIMUM STANDARD DEDUCTION PROVISION OF THE COMMITTEE FLOOR AMENDMENT—BY ADJUSTED GROSS INCOME CLASS: 1975 INCOME LEVELS [1]

Adjusted gross income class	Number of returns affected (thousands)			Decrease in tax liability	
	Total number with tax decrease	Number made nontaxable	Number shifting to the standard deduction	Amount (millions)	Percentage distribution (percent)
0 to $5,000	8,342	1,666	293	$370	13.7
$5,000 to $10,000	17,821	552	1,380	1,309	48.4
$10,000 to $15,000	10,917	10	2,018	964	35.6
$15,000 to $20,000	2,136		131	64	2.4
$20,000 to $30,000					
$30,000 to $50,000					
$50,000 to $100,000					
$100,000 and over					
Total	39,215	2,228	3,822	2,708	100.0

[1] This table represents the decrease in tax liability under the $2,000–$2,700/16 percent/$2,400–$2,800 standard deduction as compared to the $1,700–$2,100/16 percent/$2,400–$2,800 standard deduction.

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

TABLE 4.—INDIVIDUAL INCOME TAX BURDEN[1] IN 1978 UNDER THE STANDARD DEDUCTION AND EARNED INCOME CREDIT PROVISIONS APPROVED IN THE SENATE FINANCE COMMITTEE REPORT[2] AND UNDER THE STANDARD DEDUCTION AND EARNED INCOME CREDIT PROVISIONS IN THE COMMITTEE FLOOR AMENDMENT[3]

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[4]	Under report provisions	Under floor amendment provisions	Reduction	Under report provisions	Under floor amendment provisions	Reduction	Under report provisions	Under floor amendment provisions	Reduction	Under report provisions	Under floor amendment provisions	Reduction	Under report provisions	Under floor amendment provisions	Reduction
$3,000	$78	$35	$43	0	0	0	−$300	−$300	0	−$300	−$300	0	−$300	−$300	0
$5,000	415	358	57	$200	$112	$88	−209	−293	$84	−300	−300	0	−300	−300	0
$6,000	605	548	57	354	260	94	38	−53	90	−74	−158	$84	−200	−200	0
$8,000	1,016	953	63	696	586	110	561	459	102	434	338	96	200	112	$88
$10,000	1,482	1,410	72	1,076	962	114	934	820	114	791	677	114	518	418	100
$12,500	1,996	1,996	0	1,573	1,446	127	1,408	1,295	113	1,261	1,152	109	976	867	109
$15,000	2,549	2,549	0	2,029	1,996	33	1,864	1,831	33	1,699	1,666	33	1,371	1,342	29
$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	5,468	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	7,373	0

[1] Computed without reference to the tax tables.
[2] Includes the effect of the $1,700–$2,100/16 percent/$2,400–$2,800 standard deduction and the 10-percent credit on earned income phased out between $4,000 and $8,000 of adjusted gross income.
[3] Includes the effect of the $2,000–$2,700/16 percent/$2,400–$2,800 standard deduction and the 10 percent credit on earned income phased out between $4,000 and $8,000 of adjusted gross income.
[4] Wage or salary and/or self-employment income.

III. EXPLANATION OF ADDITIONAL COMMITTEE AMENDMENT TO H.R. 10612, AS REPORTED

A. TITLE XXII—ESTATE AND GIFT TAXES

1. Allowance of Credit Against Estate Tax (sec. 2201(a) of the bill and sec. 2010 of the Code)

Present law

Under present law, the estate of each decedent who was a resident or a citizen is entitled to an exemption of $60,000 for estate tax purposes. In the case of an estate of a nonresident alien, the exemption is $30,000.

Reasons for change

The present amount of the estate tax exemption was set in 1942. Since that date, the purchasing power of the dollar has decreased to less than one-third of its value in 1942. To some extent this effect has been mitigated by the addition of a provision for a marital deduction in 1948. Despite this the inflation which has occurred means that the estate tax now has a much broader impact than was originally contemplated.

In addition, since the present estate tax exemption is a deduction in determining the taxable estate, it results in a greater reduction at the estate's highest estate tax brackets. However, a credit in lieu of an exemption will have the effect of reducing the estate tax at the estate's lower estate tax brackets since a tax credit is applied as a dollar-for-dollar reduction of the amount otherwise due. Thus, at a given level of revenue cost, a tax credit tends to confer more tax savings on small- and medium-sized estates, whereas a deduction tends to confer more tax savings on larger estates. The committee believes it would be more equitable if the exemption were replaced with a credit rather than a deduction.

Explanation of provision

The committee amendment provides for a credit in lieu of the present exemption for estate tax purposes. The amount of the credit will be $30,000 for decedents dying in 1977 and increases $5,000 each year until 1981 when the credit will be $50,000. When fully effective, the $50,000 credit is approximately equivalent to a tax exemption on the first $197,000 of the decedent's taxable estate. Thus, in 1981 an estate of $197,000 or less will be exempt from estate tax. The committee amendment also makes comparable changes in the treatment of estates of nonresident aliens.

Effective date

This amendment is effective for estates of decedents dying after December 31, 1976.

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2. Increase in Estate Tax Marital Deduction (sec. 2201(b) of the bill and sec. 2056(c) of the Code)

Present law

Under present law, an estate of a decedent is granted a deduction for estate tax purposes for property passing from the decedent to the surviving spouse. The maximum allowable deduction is 50 percent of the adjusted gross estate of the decedent. The marital deduction generally equates the treatment of common law property with the treatment given to community property. The decedent's share of community property passing to a spouse is not eligible for the marital deduction because only the decedent's share is included in the gross estate as his or her property in the first instance.

Reasons for change

The committee believes that a decedent with a small- or medium-sized estate should be able to leave sufficient property directly to the surviving spouse for support during the lifetime of the spouse without the imposition of an estate tax. In addition, in practice it often is difficult to determine under present law whose efforts are responsible for the property.

Explanation of provision

The committee amendment would increase the maximum estate tax marital deduction for property passing from the decedent to the surviving spouse to the greater of $250,000 or one-half of the decedent's adjusted gross estate. In addition, the amendment contains rules which adjust the $250,000 amount where the decedent owns community property at death so that the parity provided under present law between common law property states and community property law states is continued.

Effective date

The committee amendment is to be effective for estates of decedents dying after December 31, 1976.

3. Valuation for Purposes of the Federal Estate Tax of Certain Real Property Devoted to Farming, Woodlands, Scenic Open Spaces, and Historic Sites (sec. 2201(c) of the bill and secs. 2032A, 6324B of the Code)

Present law

Under present law, the value of property included in the gross estate of the decedent is the fair market value of the property interest at the date of the decedent's death (or at the alternate valuation date if elected by the executor or administrator). The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. One of the most important factors used in determining the fair market value of land is the "highest and best use" to which the property can be put.

In some cases, the use of land for farming, woodlands, scenic or historical purposes may be its "highest and best use." However, in other cases, land which is used for such purposes might be worth significantly more if it were sold and converted to other uses, such as residential or commercial purposes. Thus, where land is used for farming, woodlands, or scenic or historical purposes, the value of the land based on actual use may be substantially less than the value of the land if it were to be converted to its highest and best use.

Reasons for change

The committee believes that, when land is actually used for farming, woodlands, scenic or historic purposes (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use." Valuation on the basis of highest and best use rather than actual use may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, etc., activities not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.

On the other hand, the committee recognizes that it would be a windfall to the beneficiaries of an estate to allow such property to be valued for estate tax purposes at a value other than its highest and best use value unless the beneficiaries continue to use the property for a reasonable period as the decedent did before death. As a result, the committee amendment provides a recapture provision where the land is prematurely sold or is converted for nonqualifying purposes.

Explanation of provision

The committee amendment provides that, if certain conditions are met, the executor may elect to value qualified real property included in the decedent's gross estate on the basis of the property's value in its current use, rather than on the basis of its fair market value in its highest and best use. However, this special valuation may not reduce the value of the decedent's gross estate by more than $1 million.

Real property qualifies for this use valuation only if it is real property used for (1) farming, (2) woodland, (3) open pastoral space, or (4) the maintenance of historic values. For property to be included in the last category, it must be listed in the National Register of Historic Places either separately or as part of a listed district.

To qualify for this special valuation, the following conditions must be met: (1) the assets in the decedent's estate devoted to qualifying uses, including both real property and personal property, must be at least 50 percent of the decedent's gross estate (reduced by debts); (2) at least 25 percent of the adjusted value of the gross estate must be qualified real property; (3) such property must pass to a qualified heir; and (4) the real property must have been owned by the decedent and devoted to a qualifying use for 5 years or more during the 8-year period ending with the date of the decedent's death. The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, grandparents, and aunts and uncles of the decedent and their descendants.

In valuing qualified real property by looking solely to its qualified use, all relevant facts and circumstances are to be taken into account. However, valuation criteria which take into account a change in use of the real property to a nonqualifying use are to be disregarded. Thus, for example, in valuing qualified real property used as a farm, the committee intends that the following factors be taken into account:

(1) The capitalization of income that the land can be expected to yield for farming purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors;

(2) The capitalization of the fair rental value of the land for farming purposes;

(3) Assessed land values in a State which provides a differential or use value assessment law for farmland;

(4) Comparable sales of other farm land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales prices; and

(5) Any other factor which fairly reflects the farm use value of the property.

The committee amendment provides that if, within 10 years after the death of the decedent, the property is disposed of to nonfamily members or ceases to be used for qualified uses,[1] the tax benefits obtained by virtue of the reduced valuation are to be recaptured. The committee amendment also requires that any executor electing the special valuation provision file an agreement signed by each person who has an interest in the specially valued property, consenting to the application of the recapture provision.

Full recapture is provided for during the first 24 months with a phaseout beginning in the 25th month. The amount to be recaptured after the 24th month is 80 percent of the total tax benefit allowed because of this special valuation. Thereafter, the recapture amount so computed is reduced on a monthly pro rata basis over 96 months (8 years). However, the potential liability for recapture would cease if the qualified heir dies without having disposed of the property or converted it to a nonqualified use.

The committee amendment provides for a special lien on all qualified real property with respect to which the special valuation is elected. The lien continues until the potential for recapture is eliminated either because the tax benefit is recaptured, the qualified heir dies, or a period of 10 years from the decedent's death lapses. This new section also allows the Treasury Department to promulgate regulations under which other security can be substituted for the lien on real property.

Effective date

These provisions apply to the estates of decedents dying after December 31, 1976.

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[1] Property ceases to be used for qualified uses not only if an actual change to a nonqualified use occurs, but also if the property is rezoned at the request of the owner to permit a nonqualifying use. In the case of property which is qualified solely because of its historic values, cessation of the qualifying use occurs if the property is removed from the National Register of Historic Places or if the owner discontinues maintenance of the historic values.

4. Extensions of Time for Payment of Estate Tax (sec. 2201(d) of the bill and secs. 6161, 6163, 6166, 6503, 6601, and 6324A of the Code)

Present law

Generally, an estate tax return is due nine months after the decedent's death. Except in certain specified situations, payment of the estate tax is required to be made with the return.

However, present law contains two provisions which permit the estate tax to be paid over a period of up to ten years after the due date of the return. First, the Secretary of the Treasury may extend the time for payment of tax up to ten years if he finds that a current payment of the tax will result in undue hardship to the estate. Second, an executor may elect to pay the estate tax in installments over two to ten years where the estate consists largely of interests in a closely held business (or businesses).

In order to qualify under the first provision, the executor must show that the payment of the estate tax on the due date would cause undue hardship. The term "undue hardship" requires more than a showing of reasonable cause or inconvenience to the estate. In general, undue hardship can be established in a case where the assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price. Further, undue hardship can be established where a farm or other closely held business could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to raise other funds for the payment of the estate tax.

Under the second provision, an executor may elect to pay the estate tax attributable to an interest in a farm or other closely held business in installments over a period not to exceed 10 years. In order to qualify under this provision, the value of the interest in the closely held business must exceed 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent. For this purpose, the term "interest in a closely held business" means an interest as sole proprietor in a trade or business; an interest as a partner in a partnership having not more than 10 partners, or in which the decedent owned 20 percent or more of the capital; or ownership of stock in a corporation having not more than 10 shareholders, or in which the decedent owned 20 percent or more of the voting stock.

Under either of these provisions, the Internal Revenue Service may, if it deems it necessary, require the executor to furnish a bond for the payment of the tax in an amount not more than double the amount of the tax for which extension is granted. In addition, the executor is personally liable for the payment of the tax unless he is discharged upon payment of the tax due and upon furnishing any bond which may be required for the tax which is not presently due because of an extension of time for payment.

Reasons for change

The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consists of a closely held business or other illiquid assets. In many cases, the executor is forced to sell the decedent's interest in the farm or other closely held business in order to pay the estate tax. This may occur even where the estate qualifies for the 10-year extension provided for closely held businesses. In this case, it may take several years before the business can regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Moreover, some businesses are not so profitable that they can yield enough to pay both the estate tax and interest where the interest rate is high.

Where a substantial portion of the estate consists of illiquid assets other than a farm or other closely held business, it has been extremely difficult to obtain an extension on the grounds of "undue hardship" because the Internal Revenue Service generally takes a restrictive approach toward granting such extensions. In addition, many executors have found it both difficult and expensive to obtain a bond to satisfy the extended payment requirements. Therefore, many executors refuse to elect the extended payment provisions because they must remain personally liable for tax for the entire length of the extension.

The committee believes that additional relief should be provided to estates with liquidity problems arising because a substantial portion of the estate consists of an interest in a closely held business or other illiquid assets. Moreover, the committee believes that the provisions should be modified so that more estates have the opportunity to take advantage of the extended payment provisions.

Explanation of provision

The committee amendment would permit the executor to elect to extend the payment of the estate tax attributable to the decedent's interest in a farm or other closely held business over a 15-year period. Under the committee amendment, the executor could defer this entire estate tax for a period of 3 years (i.e., until 3 years, 9 months after the decedent's death) and thereafter pay the tax in equal installments over the next 12 years. Interest would be due annually, including the 3-year period during which no tax need be paid.

The committee amendment provides a special 6-percent interest rate on the tax attributable to the first $1 million of farm or other closely held business property. Interest on the tax attributable to farm or other closely held business property in excess of $1 million is to bear interest at the regular rate for interest on deferred payments (currently 7 percent).

The committee amendment also substitutes a "reasonable cause" standard for the discretionary extension of estate tax payments in place of the existing "undue hardship" standard.[1] The concept of "reasonable cause" is one already found in existing law and the committee intends to adopt those standards for this purpose. Interest on amounts

[1] This "reasonable cause" standard is to replace the "undue hardship" standard for discretionary extensions of time for payment of estate tax attributable to a reversionary or remainder interest (sec. 6163(b)) as well as for discretionary extensions of time for payment of estate tax in other circumstances (sec. 6161).

deferred under this provision will continue to bear interest at the regular rate (currently 7 percent).

The committee amendment also provides a special lien on property for payment of the deferred taxes attributable to a closely held business. Where this lien procedure is followed and a party is designated to make estate tax payments and receive and transmit notices to or from the Internal Revenue Service, the executor is to be discharged from personal liability and will not be required to post a bond equal to twice the amount of the tax deferred.

Effective date

These provisions are to apply to estates of decedents dying after December 31, 1976.

5. Generation-Skipping Transfers (sec. 2202 of the bill and secs. 2601, 2602, 2603, 2611, 2612, 2613, 2614, 2621, and 2622 of the Code)

Present law

Under present law, a Federal gift or estate tax is generally imposed upon the transfer of property by gift or by reason of death. However, the termination of an interest of a beneficiary (who is not the grantor) in a trust, life estate, or similar arrangement is not a taxable event unless the beneficiary under the trust has a general power of appointment with respect to the trust property.

This result (nontaxability) occurs even when the beneficiary under the trust has: (1) the right to receive the income from the trust; (2) the power to invade the principal of the trust, if this power is subject to an ascertainable standard relating to health, education, support, or maintenance; (3) a power (in each beneficiary) to draw down annually from his share of the principal the greater of 5 percent of its value or $5,000; (4) a power, exercisable during life or by will, to appoint any or all of his share of the principal to anyone other than himself, his creditors, his estate or the creditors of his estate; or (5) the right to manage the trust property by serving as trustee.

Currently, all States (except Wisconsin and Idaho) have a rule against perpetuities which limits the duration of a trust. While the rules of the different States are not completely uniform, in general, such laws require that the ownership of property held in trust must vest in the beneficiaries not later than the period of the lifetime of any "life in being" on the date of the transfer, plus 21 years (and 9 months) thereafter.

Reasons for change

The purpose of the Federal estate and gift taxes is not only to raise revenue, but also to do so in a manner which has as nearly as possible a uniform effect, generation by generation (taking into account as the progressive rate structure does, the differences in the utility of assets according to the value held). These policies of revenue raising and equal treatment are best served where the transfer taxes (estate and gift) are imposed, on the average, at reasonably uniform intervals. Likewise, such policies are frustrated where the imposition of such taxes is deferred for very long intervals, as is possible, under present law, through the use of generation-skipping trusts.

Present law imposes transfer taxes every generation in the case of families where property passes directly from parent to child, and then from child to grandchild. However, where a generation-skipping trust is used, no tax is imposed upon the death of the child, even where the child has an income interest in the trust, and substantial powers with respect to the use, management, and disposition of the trust assets. While the tax advantages of generation-skipping trusts are theoretically available to all, in actual practice these devices are more valuable (in terms of tax savings) to wealthier families. Thus, generation-skipping trusts are used more often by the wealthy.

Generation skipping results in inequities in the case of transfer taxes by enabling some families to pay these taxes only once every several generations, whereas most families must pay these taxes every generation. Generation skipping also reduces the progressive effect of the transfer taxes, since families with moderate levels of accumulated wealth may pay as much or more in cumulative transfer taxes as wealthier families who utilize generation-skipping devices.

The committee recognizes that there are many legitimate nontax purposes for establishing trusts. However, the committee also believes that the tax laws should be neutral and that there should be no tax advantage available in setting up trusts. Consequently, the committee amendment provides that property passing from one generation to successive generations in trust form should, for estate tax purposes, be treated substantially the same as property which is transferred outright from one generation to a successive generation.

Explanation of provision

The committee amendment imposes a tax in the case of generation-skipping transfers under a trust or similar arrangement (such as a life estate) upon the distribution of the trust assets to a generation-skipping heir (for example, a grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's child).

The tax would be substantially equivalent to the estate or gift tax which would have been imposed if the property had actually been transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor's child, with remainder to the grandchild. then, upon the death of the child, the tax would be computed by adding the child's portion of the trust assets to the child's estate, and computing the tax at the child's marginal estate tax rate.

Thus, under the committee amendment, the child would be treated as a "deemed transferor" of the trust property. The child's estate tax brackets are used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer, but the child's estate is not liable for the payment of the tax. Instead, the tax would generally be paid out of the proceeds of the trust property. However, the trust would be entitled to any unused portion of the estate tax credit for the child's estate, and to the benefit of any increased marital deduction allowed to the estate as a result of the transfer. In addition, the charitable deduction would be allowable if part of the trust property were left to charity. The previously taxed property credit would also be allowable where an estate tax had been imposed with respect to the creation of the trust and, within a 10-year period thereafter, the generation-skipping tax is imposed upon the death of the child.

The committee amendment provides that the tax would be imposed whenever the child, or other member of an intervening generation, had an income interest in the trust, or a power to invade corpus for his own benefit. The tax would not be imposed, however, where the child (as trustee for his children, for example) had nothing more than a right of management over the trust assets or a limited power of appointment among grandchildren or more remote descendants of the grantor.

Also, under the committee amendment, the tax would not be imposed in the case of an outright transfer from a parent to a grandchild (because the intervening generation receives no direct benefit from such a transfer). Likewise, a trust established for the benefit of the grantor's spouse, with the remainder outright to the grandchildren, would not be subject to the tax because the intervening generation has no interest in the trust. In addition (as a rule of administrative convenience), tax would not be imposed in the case of distributions of accounting income from a generation-skipping trust to a grandchild of the grantor.

The tax under these rules would be imposed only once each generation. Generally, a generation would be determined along family lines, where possible (i.e., the grantor, his wife, and his brothers and sisters would be one generation; their children would be a second generation; the grandchildren would be the third generation, etc.).

Where generation-skipping transfers are made outside the family, generations would be measured from the grantor. Individuals not more than 12½ years younger than the grantor would be treated as members of his generation; individuals more than 12½ years younger than the grantor, but not more than 37½ years younger, would be considered members of his children's generation, etc. In cases where generation-skipping transfers are made outside the family, the deemed transferor (that is, this base for purposes of determining the tax) would be the estate of the person having the closest relationship to the grantor or the person having the intervening life interest or power (generally, the person named in the grantor's will or trust instrument).

Effective date

In general, these provisions are to apply to generation-skipping transfers which occur after April 30, 1977. However, under a transitional rule provided by the committee amendment, the tax is not to be imposed for a 10-year period (until January 1, 1987) in the case of transfers: (a) under irrevocable inter vivos trusts in existence on April 30, 1977 (except to the extent that transfers are made from such trusts out of assets added to the trust after April 30, 1977, or (b) in the case of decedents dying before January 1, 1978, pursuant to a will (or revocable trust) which was in existence on May 1, 1977, and which was not amended or revoked at any time after that date. The purpose of this transition rule is to give beneficiaries under trusts which may have been created in reliance on existing law a 10-year grace period in which to relinquish their interests in the trust, if they wish to do so, thereby eliminating the generation-skipping aspect of the trust without liability for the tax imposed under these provisions (or for gift tax in the event of such a relinquishment). In addition, the postponement of the effective date allows the committee to conduct further hearings to reexamine the provision.

6. Gift Tax Treatment of Certain Annuities (sec. 2203 of the bill and sec. 2517 of the Code)

Present law

For estate tax purposes, an exclusion is provided for the portion of the value of a survivor benefit (e.g., an annuity) under a qualified plan that is attributable to contributions made by the employer. A parallel exclusion is provided for gift tax purposes.

In 1972, the estate tax provision was amended to ensure that no portion of the employer contributions was includible in the gross estate of the employee's spouse if the spouse predeceased the employee and the couple had resided in a community property State. This amendment was designed to overturn Rev. Rul. 67–278, 1967–2 C.B. 323, which held that, if under community property laws the deceased spouse had a vested interest in one-half of such contributions, this half was includible in the spouse's gross estate and was not eligible for the exclusion because the deceased spouse was not an employee covered under the plan.

However, no corresponding amendment has been made to the gift tax provisions. As a result, the IRS has ruled that, if an employee predeceases the employee's spouse in a community property State, the surviving spouse is to be treated as having made a gift of one-half of any benefits payable to other beneficiaries. Such a result would not occur in a non-community property State.

Reasons for change

The committee believes that the treatment described above is discriminatory and should not be allowed to continue. It is the view of the committee that the provisions exempting from the estate and gift tax interests in qualified plans should have uniform application in both common law and community property States regardless of which spouse dies first.

Explanation of provision

Consequently, the committee has adopted an amendment which provides a gift tax exclusion for the value, to the extent attributable to employer contributions, of any interest of a spouse in specified employee contracts, or trust or plan payments, where two conditions exist.

First, an employer must have made contributions or payments on behalf of an employee (or former employee) under a qualified employee's pension, stock bonus, or profit-sharing plan, or trust which is qualified as an exempt plan for tax purposes (under section 401 (a)), an employee's qualified retirement annuity contract (covered under a plan described in section 403(a)), or a retirement annuity contract purchased for an employee by an employer which is an educational organization (referred to in sec. 170(b)(1)(A)(ii)) or a publicly-supported educational, charitable, or religious organization (referred to in sec. 170(b)(1)(A)(vi)). Second, for purposes of the existing estate tax provision (sec. 2039(c)), the amount involved must not be considered as contributed by the employee. Where these two conditions exist, the value of the nonemployee's interest payable to other beneficiaries upon the employer's death is to be excluded from the taxable gifts of the surviving spouse to the extent the value of the interest is attributable to the contributions of the employer and to the extent the value arises solely by reason of the spouse's interest in the community income of the employee under the community property laws of the State.

This provision will have the effect of equating the gift tax treatment that occurs upon the death of an employee spouse in a community property State with that resulting upon the death of an employee. The amount of benefits payable to other beneficiaries which are attributable to the nonemployee spouse's community interest in the value of the employer's contribution to the plan would be excluded from such spouse's taxable gifts for gift tax purposes.

This provision does not, in the case of the nonemployee spouse in the community property State, provide any exclusion for a property interest in the plan to the extent it is attributable to the contributions of the employee spouse. Thus, the surviving spouse's community interest in the plan which is attributable to contributions made by the deceased employee spouse could be subject to the gift tax, as under present law.

Effective date

The amendment applies to calendar quarters beginning after December 31, 1976.

Revenue effect of estate and gift tax provisions (Items 1 through 6)

These estate and gift tax provisions are estimated to reduce budget receipts by $1,042 million in fiscal year 1978, $1,367 million in fiscal year 1979, and $2,006 million in fiscal year 1981.

B. TITLE XXIII—OTHER AMENDMENTS

1. Outdoor Advertising Displays (sec. 2301 of the bill and sec. 1033(g) of the Code)

Present law

Under present law, gains from involuntary conversions of property (including casualties and condemnations) are, in general, allowed nonrecognition treatment where money realized from the involuntary conversion is reinvested, within a limited period of time, in property which is similar or related in service or use to the property converted (sec. 1033). A special rule is provided for condemnations of business or investment real estate (other than inventory property) under which more liberal rules are adopted for purposes of determining whether a purchase of replacement real estate qualifies as similar or related in service or use to the property converted (sec. 1033(g)).

The Internal Revenue Service has ruled that outdoor advertising billboards and displays are real property for purposes of the investment credit and depreciation recapture.[1] However, this administrative interpretation has been successfully challenged in several court cases which hold that billboards are tangible personal property (and not real property) for purposes of the investment credit.[2]

Reasons for change

Federal and State highway beautification statutes authorize the Government to condemn and purchase privately-owned highway billboards. Because of continuing restrictions on where highway billboards may be located, the former owners of condemned billboards (particularly small companies) are prevented from using their condemnation awards to build and situate replacement billboards; these taxpayers have been forced instead to reinvest their awards in other types of real property. The committee is concerned that present uncertainties in the property classification of billboards will prevent these reinvestments from qualifying for treatment as involuntary conversion replacement property. It has, therefore, decided to allow taxpayers an election to treat outdoor advertising displays as real property in certain situations.

Explanation of provision

The committee's decision provides an election for taxpayers to treat outdoor advertising displays as real property. This election, once made, is irrevocable without the permission of the Secretary to change it and it applies to all qualifying outdoor advertising displays of the

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[1] Rev. Rul. 68-62, 1968-1 C.B. 365.

[2] See, e.g., *Alabama Displays, Inc. et al.* v. *United States*, 507 F.2d 844 (Ct. Cls. 1974); *Whiteco Industries, Inc.*, 65 T.C. 664 (1975).

taxpayer. Outdoor advertising displays do not qualify for the election where the taxpayer has previously treated the property as tangible personal property by claiming either the investment credit or additional first-year depreciation. This limitation is necessary to prevent abuse of the election by treating the same property as tangible personal property for purposes of the investment credit and as real property for purposes of the involuntary conversion replacement property and depreciation recapture rules.

The term "outdoor advertising display" includes rigidly assembled outdoor signs and displays which are attached to the ground, a building, or other permanent structure for purposes of displaying advertising messages to the public. This term includes highway billboards attached to the ground with wood or metal poles, pipes or beams, with or without concrete footings.

The amendment also provides that replacement real property will be considered "like kind" property even though a taxpayer's interest in the replacement property is different from the real property interest held in a qualified outdoor advertising display which was involuntarily converted. This is to enable, for example, purchases of replacement property to qualify under section 1033(g) even though a fee simple interest in real estate is acquired to replace in part a billboard owner's leasehold interest in real property on which the billboard was located.

There is no comparable provision in the House bill.

Effective date

The election under the amendment may be made for purposes of classifying replacements of qualifying outdoor advertising displays in taxable years beginning after 1970. It is contemplated that the Secretary will allow taxpayers who have previously made replacements of qualified outdoor advertising displays during closed taxable years a sufficient period of time to make an election for these closed years.

Revenue effect

It is estimated that this provision will have no effect on budget receipts.

2. Tax Treatment of Large Cigars (sec. 2302 of the bill and secs. 5701(a), 5702, and 5741 of the Code)

Present law

Under present law (sec. 5701(a)(2)), the manufacturers excise tax on large cigars (those weighing more than 3 pounds per thousand cigars) is imposed on the basis of a bracket system with the rate of tax dependent on the retail price of the cigar. The brackets are as follows:

Intended retail price per cigar (in cents)		
Over—	Not over—	Tax per thousand
0	2½	$2.50
2½	4	3.00
4	6	4.00
6	8	7.00
8	15	10.00
15	20	15.00
20		20.00

The retail price of a cigar is defined for Federal tax purposes as "the ordinary retail price of a single cigar in its principal market." The law provides that any State or local tax imposed on cigars as a commodity is to be excluded when determining the ordinary retail price.

Reasons for change

The present bracket system is arbitrary in that it produces widely varying effective rates of tax depending on the retail price of the cigar. For cigars intended to retail for 20 cents each or less, the effective rate of tax depends on a combination of the rate of tax for the given bracket and the point within the bracket that a cigar is intended to sell for. Thus, in the wide bracket covering cigars intended to retail for over 8 cents and not over 15 cents, the tax rate of $10 per thousand varies from a maximum of 12 percent of the intended retail price (including the tax) for cigars priced at three for 25 cents to a minimum of 6.7 percent for cigars intended to retail for 15 cents each. This 6.7-percent minimum effective rate also applies to cigars at the top of the over 4 cents and not over 6 cents bracket. However, in the over 6 cents and not over 8 cents bracket, the minimum effective rate is 8.8 percent. At the very bottom of the tax scale (namely, in the case of cigars intended to retail for not more than 2½ cents each), the tax of $2.50 per thousand imposes an effective rate of 10 percent of the retail price for cigars intended to retail at two for 5 cents.

A corollary of the variability of the effective rates of tax is the fact that a shift in the price of a cigar from the top of one bracket to the bottom of the next tax bracket can result in a tax increase disproportionate to the price increase. An example of this is the increase in tax from $4 to $7 per thousand between cigars intended to retail for 6 cents and those intended to retail for more than 6 cents and not over 8 cents. At the 6-cent level, the tax is 6.7 percent of the retail price and 10.4 percent of the manufacturer's net price (exclusive of tax).[1] If the manufacturer of a 6-cent cigar raised the stated retail price to three for 20 cents, the effective rate of tax would increase to 10.5 percent of the retail price and 17.5 percent of the manufacturer's net price. The manufacturer would net only $1.70 more per thousand cigars although consumers would pay $6.67 additional. This bracket system not only discriminates among producers depending on the price at which they sell their cigars within a bracket but also prevents manufacturers from freely adjusting prices to meet cost changes.

There is no way to determine precisely how the burden of the cigar tax is distributed between consumers and owners of manufacturing firms. In either event, however, the present tax is discriminatory. To the extent it is borne by consumers, the burden imposed by the tax varies erratically depending on the intended retail price of the cigars purchased. To the extent it is borne by manufacturers, the burden of the tax varies depending on the particular price lines produced by each manufacturer. As a percent of sales, the tax paid is least for those manufacturers whose production is concentrated in price classes where the effective rate of tax is at a minimum.

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[1] This assumes the usual standard markup in determining the retail price.

These problems of the bracket system have been recognized for a long time by the cigar industry, the Treasury Department, and the Congress. When the tax on cigars was collected by means of the purchase of stamps, practical consideration favored the use of some type of bracket system in order to keep to a reasonable level the number and denomination of stamps that had to be printed. However, the use of stamps as evidence of payment of tax was discontinued in June 1959. As a result, there now is no reason why the bracket system should not be eliminated.

A change from a tax base of the intended retail price to a base of the intended wholesale price will make administration of the tax easier and avoid many of the problems associated with the present tax base of the intended retail price in the cigar's principal market. Administration of the tax will be facilitated because wholesalers traditionally sell a given cigar at the same price to different retailers. Retail prices do not have this consistency. In addition, verification that sales actually take place at the list price will be easier than in the case of the intended retail price because there are far fewer wholesalers than retailers.

With a tax based on the wholesale price rather than the retail price, a rate of 10 percent is required in order to produce the same tax yield as is produced under present law. However, if a substantial tax increase is not to result for many cigars, a rate which is lower than this is required. Substitution of an ad valorem rate of tax for the present bracket system, of necessity, has a differing impact on individual firms within the cigar manufacturing industry.

An ad valorem rate set at 10 percent of the wholesale price would mean that those firms which have produced cigars which sold at prices where the tax rate was relatively low under the bracket system would be faced with a tax increase with such a rate. Firms producing cigars at prices where the tax rate has been relatively high under the bracket system, of course, would obtain some benefit under a 10-percent rate structure. In a transition of this type, however, in order to prevent a tax increase for a large number of lines of cigars, a reduction in the average rates of tax is necessary.

In addition to the need for a tax rate decrease because of a shift to an ad valorem system, a decrease in the rate of tax for cigars also is justified for other reasons as well. First, when many excise taxes were reduced or eliminated in 1965, the tax on cigars was nevertheless maintained at preexisting rates. Second, the cigar industry in recent years has been experiencing considerable financial difficulty. Sales have dropped dramatically from 9 billion cigars in 1964 to about 6 billion in 1975—a period of rising costs.

Explanation of provision

This amendment changes the present law tax on large cigars (those weighing more than 3 pounds per thousand [2]) to a tax of 8½ percent of the wholesale price, but not more than $20 per thousand cigars.

Wholesale price, as defined in this amendment, means the manufacturer's or importer's suggested delivered price of the cigar to retailers (including in this price this Federal cigar tax). This price is to be determined before any trade, cash, or other discounts, or any promotion,

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

advertising, display, or similar allowances. Generally, this wholesale price is the traditional manufacturer's or importer's declared intended catalog or list delivered bulk price to retailers. Where the manufacturer or importer has no suggested delivered price to retailers for the particular cigar in question (as may happen, for example, if he sells only at retail, or where the suggested delivered price to retailers is not adequately supported by bona fide arm's length sales), the amendment provides that the wholesale price is to be determined by the Treasury Department on the basis of the price for which cigars of comparable retail price are sold to retailers in the ordinary course of trade.

In most cases the wholesale price will be adequately supported by sales by the wholesalers to retailers. In only a few situations will it be necessary for the Treasury Department to determine the wholesale price on the basis of the price for which cigars of the same or comparable retail price are sold to retailers in the ordinary course of trade.

The use of the intended wholesale price as the tax base will eliminate the troublesome determination of the retail price of a single cigar in its principal market.

The wholesale price does not include State or local taxes imposed on cigars as a commodity. The present law exclusion of such taxes from the tax base is continued by this amendment. If a manufacturer normally includes State or local taxes in his "wholesale price," he must show the price net of any such taxes in a manner satisfactory to the Treasury Department for the purpose of imposing the tax provided by this amendment.

This amendment also amends the Code (sec. 5741) to include importers among those persons required to keep records prescribed by the Treasury Department and to provide that the required records be available for inspection by internal revenue officers during business hours. The existing statutory requirement is extended to importers in order to avoid any doubt that appropriately prescribed regulations may require them to keep records which are needed. This is particularly relevant with the change in manner of imposition of the tax on large cigars and the added definition of "wholesale price" which will likely result in a requirement that records be kept by importers.

There is no comparable provision in the House bill.

Effective date

The effective date of the changes made by this amendment is the first day of the first month which begins more than 90 days after the date of enactment. This date provides taxpayers and the Treasury Department with sufficient time to make the required administrative changes.

Revenue effect

This provision will reduce budget receipts by $7 million in fiscal year 1977, $7 million in fiscal year 1978, and $7 million in fiscal year 1981.

3. Treatment of Gain from Sales or Exchanges Between Related Parties (sec. 2303 of the bill and sec. 1239 of the Code)

Present law

Under present law, recognized gains from a sale or exchange of depreciable property are denied capital gain treatment if the transaction is between a husband and wife, or between an individual and a corporation over 80 percent of the value of whose stock is owned by the individual, his spouse, and his minor children or grandchildren (sec. 1239). This rule applies where the shareholder sells property to his controlled corporation, and vice versa.

Although the present statute covers a sale or exchange "directly or indirectly" between an individual and a controlled corporation, the courts have held that this language does not reach gain on a sale of depreciable property between two corporations each of which is more than 80 percent controlled by the same individual and his family. The courts have refused to follow a ruling by the Internal Revenue Service that a sale between two such commonly controlled corporations is (for purposes of this provision) "indirectly" a sale between the individual and the corporation.[1]

Reasons for change

In enacting section 1239 (and its predecessors in the 1939 Code), Congress sought to prevent the practice of selling a low basis-high value depreciable asset to a controlled corporation in order to "step up" the basis of the asset for depreciation purposes in the hands of the corporation at the cost of a capital gain tax to the selling shareholder.[2] The corporation's basis would be its cost for the property, which in turn would reflect appreciation in value in the hands of the shareholder.

In refusing to interpret "indirectly" to cover commonly controlled corporations, the courts have not disagreed that corporations under common control can and do engage in sales or exchanges with each other to obtain the tax benefits which Congress sought to prevent if the sale were made directly between the shareholder and the corporation. The courts, however, have generally based their decisions on technical factors involving the language of the present statute and some ambiguity in the legislative history of the provision.

The potential for abuse is as evident in such cases, however, as in sales between a shareholder and his controlled corporation. In both situations, the shareholder (or his family) maintains control over the asset while the corporation obtains a higher depreciable basis in the property. The committee sees no reason why a sale between corporations controlled by the same individual should be treated differently from a sale between an individual and his controlled corporation should be treated differently (under section 1239)[3] from a sale between corporations controlled by the same individual.

No rules of constructive ownership are provided in section 1239 for purposes of determining the ownership of stock under that provision. As a result, a taxpayer may be able to structure a transaction to circumvent the applicability of the section. For example, a taxpayer desiring to sell depreciable property to a corporation which he wholly owns may be able to avoid section 1239 by (prior to the sale) contrib-

[1] Rev. Rul. 69-109, 1969-1 C.B. 202.

[2] H. Rept. 586, 82d Cong., 1st Sess. (1951), 1951-1 C.B. 357, 376. The committee report states that this type of transaction may be highly advantageous "when the sale may be carried out without loss of control over the asset because the corporation to which the asset is sold is controlled by the individuals who make the sale."

[3] The depreciation recapture rules of sections 1245 and 1250 would have a limited use to prevent this abuse where sales are made between controlled corporations of property which has a low basis but a high value. In such cases, sections 1245 and 1250 would recapture as ordinary income only a relatively small portion of the seller's gain.

uting his stock in the corporation to a holding company or by transferring 20 percent of his stock to a trust for the benefit of members of his family. Although it can be argued that the taxpayer continues to own the stock "indirectly" and section 1239 therefore should come into play, as explained above, the courts have been reluctant to give a broad interpretation to the term "indirectly."

Explanation of provision

The committee amendment revises and strengthens section 1239 in several ways. First, the amendment adds a rule which brings within the scope of this provision a sale or exchange of property between commonly-controlled corporations. Second, the amendment makes rules of constructive ownership applicable in determining stock ownership under this provision generally. For this purpose, the present rules which apply under section 318 are incorporated by reference. Third, the amendment changes the control requirement which brings section 1239 into effect from over 80 percent to 80 percent or more in value of a corporation's stock. (This latter change follows the concept of control reflected in the reorganization rules, where control means at least 80 percent or greater control (sec. 368(c)).

Under the first of the changes made by the committee, the treatment of gain as ordinary income in the case of a sale between commonly controlled corporations is to occur at the level of the transferor (seller) corporation rather than at the level of the shareholder. The constructive ownership rules are to be used to determine whether the 80 percent stock ownership requirement has been met, but (in the commonly controlled corporation situation) the actual tax effect of recharacterizing gain as ordinary income is to occur at the corporate level.[4]

The committee does not intend to prevent section 1239 from being invoked to produce ordinary income to a shareholder where a corporation is used as a conduit to make a sale to another controlled corporation, or where the entity of a corporate transferor is properly disregarded for tax purposes. These situations will result in ordinary income to the shareholders.[5]

The incorporation of constructive ownership rules into section 1239 applies generally to this section and is not limited to sales between commonly controlled corporations. In light of the section 318 rules, the 80-percent requirement of section 1239 will continue to be measured by reference to the value of the company's outstanding stock; however, the stock which will be grouped together in measuring control will include stock considered owned by an individual under the constructive ownership rules. Thus, for example, if a father owns outright 79 percent of the stock (by value) of a closely held corporation and a trust for his children owns the remaining 21 percent of the stock, the children will be deemed to own the stock owned for their

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[4] If the transferor corporation is a subchapter S corporation (i.e., a corporation which has made an election under sections 1371–1379 of present law), gain which is denied capital gain treatment by reason of the committee amendment will be included in the corporation's undistributed taxable income which is taxed to its shareholders (pursuant to sec. 1373 of the Code).

[5] The committee's amendment bringing sales between certain controlled corporations within section 1239 also is not intended to make such sales less subject (than they are under present law) to allocations of income between or among the corporations or their shareholders under section 482 of present law. Nor is the amendment intended to make such sales no longer subject to constructive dividend treatment to the controlling shareholder (as may occur in appropriate cases under present law).

benefit by the trust in proportion to their actuarial interests in the trust (sec. 318(a)(2)(B)). The father will, in turn, constructively own the stock so deemed to be owned by his children (sec. 318(a)(1)(A)(ii)). The result will be that the father will be treated as owning all the stock of the corporation, and any gain he would otherwise have to recognize from selling depreciable property to the corporation would be treated by section 1239 as ordinary income.

Also, the constructive ownership rules mean, among other things, that if a shareholder holds an option to acquire stock (such as from another shareholder), he will be treated as owning the stock which he could acquire by exercising the option (sec. 318(a)(4)). The members of a shareholder's family are also broadened beyond a spouse, minor children, and grandchildren to include parents and adult children (sec. 318(a)(1)).[6]

There is no comparable provision in the House bill.

Effective date

This provision applies to gain recognized on a sale or exchange made after the date of enactment of the amendment. A transition rule is also provided under which the new rules will not apply to a sale or exchange after the date of enactment but occurring pursuant to a binding contract entered into before the date of enactment.

Revenue effects

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

4. Application of Section 117 to Certain Education Programs for Members of the Uniformed Services (sec. 2304 of the bill and sec. 117 of the Code)

Present law

Amounts received by an individual as a scholarship or fellowship grant for study, research, etc., at a qualified educational institution (as defined in sec. 151(e)(4)) are generally excluded from gross income (sec. 117(a)). However, such amounts are not excludible from gross income if they represent compensation for past, present, or future employment services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Regs. § 1.117-4(c)).

During calendar years 1973, 1974, and 1975, amounts received from appropriated funds as a scholarship (including the value of contributed services and accommodations) by a member of a uniformed service[1] who was receiving training under the Armed Forces Health

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[6] As another example of the effect of the stock attribution rules, assume that a shareholder owns 80 percent of corporations *A* and *B*. The shareholder attempts to plan around the rule in the amendment bringing sales between controlled corporations within section 1239 by contributing his stock in corporation *B* to newly formed holding company *C*, which the shareholder wholly owns, and then having *A* sell depreciable property to *B*. Without attribution, this sale might be found (under present law) not to be covered by section 1239. However, the attribution rules under the amendment will treat the shareholder as owning the *B* stock owned by holding company *C*, so that *A*'s gain on the sale will be ordinary income

For purposes of section 1239, attribution to a shareholder of stock owned by a corporation, *or vice versa, is to occur without regard to the 50-percent limitation contained* in sections 318(a)(2)(C) and 318(a)(3)(C).

[1] As defined under 37 U.S.C., Sec. 101(3).

Professions Scholarship Program [2] (or any other similar program, as determined by the Secretary of the Treasury) were specifically excluded from gross income by congressional action.[3] This exclusion was available whether the member was receiving training while on active duty or in an off-duty or inactive status, and without regard to whether a period of active duty was required of the member as a condition of receiving those payments.

Reasons for change

The Internal Revenue Service has ruled (Rev. Rul. 76-99) that, without further legislation, all amounts received under the Armed Forces Health Professions Scholarship Program will be treated as compensation and therefore includible in gross income for calendar years 1976 and thereafter. In view of the Congressional and executive concern regarding the need for these health professions scholarships for the uniformed services, the committee concluded that those scholarships should continue to be excluded from gross income pending a thorough staff review of the appropriate tax treatment of the grants in view of the overall national policy toward the military (and other uniformed service) health professions program.

Explanation of provision

The committee amendment extends the prior law exclusion from gross income (under P.L. 93-483) for amounts received under the Armed Forces Health Professions Scholarship Program (or substantially similar programs) for one more year (1976). This will give the committee additional time to determine the appropriate tax treatment of those scholarship programs. The House bill contains no similar provision; however, the House Committee Report on H.R. 10612 states that the Committee on Ways and Means, with the assistance of the Internal Revenue Service, will study the tax treatment of scholarships and fellowships.

Effective date

This provision is effective for amounts received during calendar year 1976.

Revenue effect

It is estimated that this provision will decrease budget receipts by $2 million in the transition quarter and $3 million in fiscal year 1977.

5. Tax Counseling for the Elderly (sec. 2305 of the bill and sec. 7803(a) of the Code)

Present law

Present law provides a number of tax benefits for elderly or retired individuals; however, it contains no provision dealing with tax counseling for the elderly.

Reasons for change

Preparation of a tax return is frequently a difficult task for the elderly. Upon reaching retirement age, taxpayers are often confronted

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[2] Authorized by the Uniformed Services Health Professions Revitalization Act of 1972 (10 U.S.C., secs. 2120-2127).
[3] Public Law 93-483 (H.R. 12035; 93rd Congress, 1st sess.), October 24, 1974.

with new provisions and complex forms to contend with. They often must complete a retirement income credit schedule, determine the taxable portion of their annuities, or compute the taxable gain when they sell their residences. For an untrained elderly individual, who has perhaps had no experience with the preparation of tax returns other than the short form 1040A, this change in circumstances may result in overpayment of tax.

Explanation of provision

The amendment authorizes the Secretary of the Treasury, through the Internal Revenue Service, to enter into training and technical assistance agreements with private or public nonprofit agencies and organizations to prepare volunteers to provide tax counseling assistance for elderly individuals in the preparation of their Federal income tax returns. It permits the Service to provide reimbursement to volunteers for transportation, meals, and other expenses incurred by them in training or providing counseling assistance. The amounts received by the volunteer as reimbursement for these expenses are to be exempt from income and social security taxes, except to the extent that a charitable contribution or other deduction is claimed for these expenses. The Secretary is authorized to provide the volunteers with preferential access to Internal Revenue Service taxpayer service representatives and make available technical information and material needed for their use.

The amendment also authorizes the Secretary to hire retired former Internal Revenue Service employees who could, under this committee amendment, work up to 720 hours a year without losing their pensions. These temporary employees would primarily be used to provide tax assistance services, but the Service is also given authority to use these individuals to administer and enforce the tax laws. Additionally, the amendment provides that, from time to time, the IRS is to direct the attention of elderly individuals concerning tax measures of particular interest to the elderly, such as the retirement income credit. An "elderly individual" is defined as a person who has reached the age of 60 as of the close of a taxable year.

Appropriations to carry out these provisions are authorized by the amendment in the amounts of $2 million for fiscal 1978 and $3 million for fiscal 1979.

The House bill contains no comparable provision.

Effective date

This provision is to be effective on the date of enactment.

Revenue effect

It is estimated that this provision will have little effect on Federal revenues, but will involve expenditures of up to $2 million for fiscal year 1978 and up to $3 million for fiscal year 1979.

6. Credit for Certain Expenses Incurred in Providing Education (sec. 2306 of the bill and sec. 44D of the Code)

Present law

Under present law, there is no tax credit or deduction for personal educational expenses. However, a deduction may be taken for certain educational expenses which qualify as trade or business expenses under section 162. In addition, individuals may generally exclude from gross income amounts received as scholarships or fellowships (sec. 117).

Reasons for change

The cost of a college education has increased dramatically in recent years. The committee is concerned about the growing number of qualified students who are prevented from obtaining a higher education because of the increasing costs. The escalating costs are making it increasingly difficult for many parents to provide their dependents with a higher education. The impact of rising college education costs has been particularly hard on middle-income families. Low-income families are eligible for the various Government programs providing direct grants, work-study programs, and guaranteed or low-interest loans, while high-income families are generally able to afford college expenses. The committee believes that tax assistance is necessary to help assure a greater access to a higher education.

Explanation of provision

The amendment provides a nonrefundable tax credit for certain education expenses paid by an individual, for himself, his spouse, or his dependents. The amount of the credit for each student is not to exceed $100 for expenses paid in 1977 and increases by $50 each year until it reaches a limit of $250 for expenses paid in 1980 and subsequent years. Subject to this limitation, the credit is allowed for 100 percent of the eligible educational expenses. There is no comparable provision in the House bill.

The education expenses which are eligible for the credit are the tuition and fees required for the enrollment or attendance of a student at an eligible educational institution and the fees, books, supplies, and equipment required for courses of instruction at an eligible educational institution. The credit is not available for any amount paid directly or indirectly for meals, lodging, or other personal, living, or family expenses.

To be eligible for the credit, the education expenses must be paid with respect to an individual who is, for at least 4 months during the calendar year, a full-time student above the secondary level at an institution of higher education (as described in the Higher Education Act of 1965) or at a vocational school (as defined in the Vocational Education Act of 1963). The tax credit is available only for amounts attributable to instruction for which course credit is allowed toward a baccalaureate degree by an institution of higher education or toward a certificate of required course work or training at a vocational school. The credit is not available for expenses attributable to graduate work or for recreational or noncredit courses. However, the credit is available for individual graduate-level classes taken for credit toward a baccalaureate degree. In the case of an integrated graduate/undergraduate program (for example, a program leading to the degrees of B.S. and D.D.S.), it is intended that the Internal Revenue Service will develop rules allocating expenses between undergraduate and graduate programs.

The amount of educational expenses eligible for the credit for an individual is to be reduced by the amount received by that individual as a tax-exempt scholarship or fellowship grant or under the GI Bill. However, unless the scholarship or benefit reduces the amount below the maximum amount against which the credit is taken, the amount of the credit is not reduced. In addition, rules are provided for the proration of the credit where more than one taxpayer pays the educational expenses of an individual. Further, no credit is allowed for the educational expenses of the taxpayer's spouse unless the taxpayer and his spouse file a joint return. No deduction is to be allowed under section 162 (relating to trade or business expenses) for any educational expense which is taken into account in determining the credit under this provision.

Effective date

This provision applies to educational expenses paid after June 30, 1977, for courses of instruction commencing after June 30, 1977.

Revenue effect

It is estimated that this provision will decrease budget receipts by $467 million in fiscal year 1978, $711 million in fiscal year 1979, and $1,103 million in fiscal year 1981.

7. Commission on Value Added Taxation (sec. 2307 of the bill)

Present law

There is no present law provision relating to a specific study of the value-added tax or other alternative tax sources. The Code (sec. 8022) does provide that the Joint Committee on Internal Revenue Taxation is to "investigate the operation and effects of the Federal system of internal revenue taxes."

Reasons for change

It appears desirable to the committee to provide for a specific study of value added taxation in order to determine its possible impact on the Federal revenue system, as well as its effect on savings, consumption, capital formation, and trade policy and as an alternative revenue source for social security financing. There is an increasing concern regarding the future financing of the social security system in view of the present reliance on payroll taxes because of the burden on lower-income workers and on smaller employers as well. Suggestions have been made for general revenue financing for part of the outlays under the present social security benefit system.

In addition, concern has been voiced by some regarding the impact of tax policy on savings and capital formation. Further, since the Western European (Common Market) countries have moved to an increased reliance on the value-added tax in recent years, there appears to be a possible competitive trade problem in view of the GATT allowance of rebates of value-added taxes on exports from these countries to the United States (and other countries) at the same time the VAT is imposed on goods imported from the United States (and other countries).

Explanation of provision

The committee amendment establishes a National Commission on Value Added Taxation. The Commission is to study the effects of the value-added tax on Government finance in general, and also is to specifically review its impact on savings, consumption, capital formation, international trade policy, as well as considering the VAT as a possible alternative source of financing the social security system. The Commission is to issue its final report to the President and Congress by December 31, 1977.

The Commission is to consist of 20 members, and the members are to be appointed as follows:

(1) two Members of the Senate appointed by the President pro tempore of the Senate (with no more than one Member from any one political party);

(2) two Members of the House of Representatives appointed by the Speaker of the House of Representatives (with no more than one Member from any one political party);

(3) the Secretary of the Treasury;

(4) the Secretary of Commerce;

(5) the Secretary of Labor;

(6) the Chairman of the Council of Economic Advisors; and

(7) twelve members appointed by the President (by and with the advice and consent of the Senate) from among individuals of the general public who are representative of industry, labor, and consumer organizations, or other individuals who are especially qualified to serve on the Commission.

The Commission is to select its own Chairman and Vice Chairman by majority vote.

The amendment authorizes an appropriation of up to $1 million to finance the study, and grants the Commission authority to hire an executive director and other necessary staff and consultants to assist the Commission in conducting the study, at rates not to exceed the maximum basic pay authorized by the General Schedules. This includes authority to pay necessary travel-related expenses of the members and staff. Commission members (other than those who are full-time officers or employees of the U.S. Government) are to receive compensation at the daily rate in effect for grade GS–18 during the time they are engaged in performing duties of the Commission.

Further, the Commission may secure directly from any Federal department or agency the information and assistance necessary to carry out its duties; such departments and agencies are authorized and directed to furnish information and assistance to the Commission to the extent permitted by law and within the limits of available funds. In addition, all meetings, hearings, conferences, or other proceedings of the Commission are to be open to the public, unless the members vote otherwise. Such a vote can be taken only at a meeting open to the public. Finally, the Commission is to cease to exist 180 days after submission of its final report to Congress.

The House bill contains no comparable provision.

Effective date

This provision is effective on the date of enactment. The appointments to the Commission are to be made within 120 days after date of enactment, and the Commission's final report to the President and Congress is due by December 31, 1977.

Revenue effect

This provision has no effect on Federal revenues, but involves an expenditure of Federal funds of up to $1 million.

8. Interest on Certain Governmental Obligations for Hospital Construction (sec. 2308 of the bill and sec. 103 of the Code)

Present law

In general, industrial development bonds are not eligible for exemption from the Federal income tax on interest income. The term industrial development bond includes obligations from which all or a major portion of the proceeds are used in a trade or business by a person other than an exempt person. An "exempt person" is defined as a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a), except for unrelated trade or business activity.

Exceptions have been made for such issues to finance certain facilities which possess elements of a public character and the development costs of industrial parks. In addition, an exemption also is provided for certain small issues which do not exceed $5 million. The exempt activities of a public character include providing residential real property for families, sports facilities, convention or trade show facilities, certain freight and passenger transportation facilities, pollution control or waste disposal facilities, and certain local public utility facilities.

Public hospitals operated by governmental units may be financed with tax-exempt bonds, but private hospitals are not eligible for financing with industrial development bonds except under the small issues exemption.

Reasons for change

The costs of constructing and equipping hospitals have escalated so rapidly in the past several years that it is not possible to construct a moderate-sized private hospital within the $5 million limitation. This is a matter of importance in many rural areas where public hospitals have not been built.

The committee decided that it would be appropriate to increase the small issues limitation as it applies to private hospitals, so long as the appropriate State government health agency certifies that construction of the hospital is necessary. This would assure that tax-exempt bonds are issued only where other local hospital facilities are inadequate or lacking.

Explanation of provision

The amendment adds a special exception from the $5 million limit for small issues which will permit issues up to $20 million for a private hospital which is certified as necessary by the appropriate State health agency. There is no corresponding provision in the House bill.

Effective date

The amendment is effective for obligations issued in taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will decrease budget receipts by $1 million in fiscal year 1977, $3 million in fiscal year 1978, and $14 million in fiscal year 1981.

9. Group Legal Services Plans (sec. 2309 of the bill and secs. 120 and 501(c)(20) of the Code)

Present law

Prepaid group legal services plans are a recent, innovative means of providing legal services. Because of the relative novelty of these fringe benefit plans and the variety of their design, the tax treatment of the employer contributions on behalf of the employee and of the benefits received by the employee under such plans has not yet been clearly established.

However, depending on the structure of the plan, it appears that the employee will be required to include in his income either (1) his share of the amounts contributed by his employer to the group legal services plan or (2) the value of legal services or reimbursement of expenses for legal services received under the employer-funded plan, or both. (If plans are funded with contributions which are partially taxable and partially tax-free to the employee, the employee may be required to include any benefits in income to the extent the contributions for the plan constitute amounts not previously included in the employee's income.)

Amounts contributed by the employer for an employee to a group legal services plan or the value of services or reimbursements if provided directly by the employer to the employee under a plan are deductible by the employer as ordinary and necessary business expenses, if they meet the usual standards for trade or business deductions.

Reasons for change

The committee believes that it is appropriate to provide a tax incentive to promote prepaid legal services plans. Within the last 3 years, the American Bar Association and many State bar associations have endorsed the creation of this type of arrangement as a means of making legal services more generally available. Several unions have alalready established prepaid group legal services plans which are supported entirely or in part by employer contributions.

The committee believes that excluding such employer contributions from the employees' income will promote interest in such plans and increase the access to legal services for many taxpayers by encouraging employers to offer and employees to seek such plans as a fringe benefit.

The committee believes a tax incentive, which would increase the availability of legal services, is especially helpful to middle-income taxpayers who at present may be the most under-represented economic group in terms of legal services. Lower-income persons have access to publicly-supported legal aid services, while taxpayers with higher incomes can generally afford their own legal expenses.

The committee believes that providing favorable tax treatment for group prepaid legal services plans (which has some similarity to the tax treatment provided for accident and health plans) will grant taxpayers some relief from the high cost of legal fees and will promote the adoption and implementation of such plans by many employers and employees.

In order to insure that the tax law encourages only those plans which may be considered nondiscriminatory employee fringe benefits, the committee believes it necessary to adopt rules which will prohibit discrimination and minimize the possibility of abuse of the tax incentive by those taxpayers who might create such plans to channel otherwise taxable compensation through a plan providing a tax-free fringe benefit.

Explanation of provision

The committee amendment excludes from an employee's income amounts contributed by an employer to a qualified group legal services plan for employees (or their spouses or dependents) as well as any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee, his spouse, or his dependents. The exclusion does not apply to direct reimbursements made by the employer to the employee. There is no corresponding provision in the House bill.

In order to be a qualified plan under which employees are entitled to the tax-free benefits provided by the amendment, a group legal services plan must fulfill several requirements with regard to its provisions, the employer, and the covered employees. These requirements are designed to insure that the tax-free fringe benefits are provided on a nondiscriminatory basis and that the possibility of tax abuse through the misuse of such plans is minimized.

A qualified group legal services plan must be a separate written plan of an employer for the exclusive benefit of his employees or their spouses or dependents. The plan must supply the employees, their spouses, and dependents with specified benefits consisting of personal (i.e., nonbusiness) legal services through prepayment of, or provision in advance for, all or part of an employee's, his spouse's, or his dependents' legal fees. Benefits must be set forth so that the employees understand what legal services are covered by the plan.

The amendment also provides that amounts contributed by employers under a plan may be paid only (1) to insurance companies, (2) to trusts (exempt under new sec. 501(c)(20), described below), (3) as prepayments to providers of legal services under the plan, or (4) to a combination of the three permissible types of payment arrangements.

In order to be a qualified plan, a group legal services plan must also meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment.

The committee amendment requires that the contributions paid by an employer and the benefits provided under a plan may not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated. The plan must benefit employees who qualify under a classification which the employer sets up and which the Service determines does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated. However, in determining whether the classification is discriminatory the employer may exclude from the calculations those employees who are members of a collective bargaining unit if there is evidence that group legal services plan benefits were the subject of good faith bargaining between representatives of that group and the employer.

A limit is placed on the proportion of the amounts contributed under the plan which can be for employees who own more than 5 percent of the stock or of the capital or profits interest in the employer corporation or unincorporated trade or business. The aggregate of the contributions for those employees and their spouses and dependents must not be more than 25 percent of the total contributions.

Under the amendment, in order to be treated as a qualified group legal services plan, the plan must notify the Internal Revenue Service that it is applying for recognition of this qualified status. If the plan fails to notify the Service by the time prescribed in Treasury regulations, then the plan cannot be regarded as a qualified plan for any period before it in fact gave notice. For example, if the Treasury regulations provide that a plan is required to notify the Service before the end of the first plan year in order to be treated as a qualified plan from the beginning of the first plan year, and the organization does not file its notice until half-way through the second plan year, then (1) the organization is not qualified for its first plan year, and (2) the organization is not qualified for that part of the second plan year preceding the date on which the notice finally was filed. However, if the notice was filed on the last day of the first plan year, then the organization would be qualified from the first day of that first plan year.[1]

Furthermore, several additional special rules and definitions are to apply to qualified group legal services plans.

An individual who is an employee within the meaning of section 401(c)(1) of the Code is, for purposes of these group legal services provisions, an "employee" and also is a "self-employed individual". This means that, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is an employee of the partnership. Under a special rule for the allocation of contributions, the Treasury Department's regulations must provide that allocations of amounts contributed under the plan shall take into account the expected relative utilization of benefits to be provided under the plan from those contributions or plan assets and the manner in which any premium charge (or retainer or other price) for the plan was developed.

The term "dependent" has the meaning given to it under section 152. Therefore, the plan may cover an individual whose relationship to the employee is listed in section 152, if the employee provides over

[1] Recognizing that existing plans are to be covered by this provision and that there may be a delay in the final publication of these notification regulations, the amendment also provides that this initial notice is to be considered timely if it is given at any time through the 90th day after the publication of the first final Treasury Regulations on this point.

half of the support for that individual for the calendar year in which the employee's taxable year begins. Since the plan must be for the exclusive benefit of employees and their spouses and dependents, the plan is not to cover any other persons.

For determining stock ownership in corporations, the amendment adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The amendment also provides that a trust created or organized in the United States, whose exclusive function is to form part of a qualified group legal services plan under section 120, is to be exempt from income tax (new sec. 501(c)(20)). Such a trust shall be subject to the rules governing organizations exempt under section 501(c), including the taxation of any unrelated business income.

Effective date

This provision applies to taxable years beginning after December 31, 1973.

The time within which a plan must apply to the Service for recognition of its status as a qualified group legal services plan under the notice requirement of this amendment is not to expire before the 90th day after the Treasury Department's regulations on this point first become final.

A written group legal services plan that was in existence on January 1, 1976, is to be treated as meeting the requirements for a qualified plan for the retroactive period under this amendment and also up to the 180th day after the bill's enactment. If, on January 1, 1976, the plan was maintained under a collective bargaining agreement, then the plan is to continue to be treated as qualifying under this amendment past the 180th day after enactment, until the termination of the last collective bargaining agreement under which the plan is maintained, but in no event past December 31, 1981. After the termination of the agreement (or on the 180th day after enactment, or on January 1, 1982, whichever applies in the particular case) the plan must comply with the antidiscrimination, etc., requirements set forth in this provision (new sec. 120) in order for the tax benefits provided by this amendment to apply.

Revenue estimate

It is estimated that this provision will decrease budget receipts by $5 million for fiscal year 1977, $8 million for fiscal year 1978, and $33 million for fiscal year 1981 (and this revenue loss will continue to increase significantly thereafter).

10. Exchange Funds (sec. 2310 of the bill and sections 368, 721, 584 and 683 of the Code)

Present law

An exchange fund is an investment entity through which large numbers of investors pool stocks or debt securities which usually are highly appreciated in exchange for shares of the fund. These arrangements allow investors to diversify their concentrated ownership of one or a few securities into a broader variety of other stocks and securities (usually publicly-traded interests in listed companies) without paying taxes on the appreciation they have, in effect, realized at the time the different stock interests are exchanged for each other.

Present law does not permit tax-free formation of an exchange fund as a corporation where the result is a diversification of the investor's portfolio. This restriction was added in 1966 after a period in the early 1960's when investment management firms publicly solicited individuals owning highly appreciated stocks or securities to pool their stocks tax-free in a newly formed corporation which would then manage the combined portfolio.

The 1966 legislation dealt only with swap funds in corporate form and did not deal with partnerships because at that time such funds could not operate in partnership form. Recently, however, a number of public syndications have been organized to sell exchange funds as partnership interests. In April, 1975, the Internal Revenue Service granted a private ruling to one fund which proposed to operate as a limited partnership, allowing investors to transfer appreciated stocks or securities to the fund without a current tax to the investor-limited partners. This ruling prompted the formation of other similar partnerships, including some which proposed to offer interests to investors privately (rather than by broad public solicitation). Several of these funds presently have ruling requests pending with the Service.

Reasons for change

Although the House bill (H.R. 10612) does not include any corresponding provision, the House, on May 3, 1976, passed H.R. 11920 which deals with the tax treatment of partnership exchange funds and mergers of certain investment companies (generally mergers of personal holding companies with mutual funds), where a taxpayer's principal interest is to diversify his investments without current payment of any tax. In general, the House bill conforms the partnership tax rules to those for corporations in the case of exchange funds and, as a result, makes taxable the transfer of appreciated stocks or securities (as well as other property) to a partnership if, as a result, the transferors' investment interests are diversified.

The committee reviewed the House-passed bill and believes that the tax-free diversification of stock investments should not be permitted through the use of the partnership form when the same result cannot be achieved under present law through a corporation or a direct exchange of portfolio stocks for other similar stocks. It appears to the committee that the principal purpose in the use of an exchange fund by depositors is to diversify their portfolios of highly appreciated stocks or securities without current payment of any tax. If a taxpayer liquidated his appreciated portfolio and invested the proceeds in a mutual fund or other diversified portfolio, however, a capital gains tax would be imposed on the gains in his own stocks. Even after joining an exchange fund, the investors do not want the managers to sell off either their own or other stocks so as to trigger a large capital gain tax at an earlier time than would have occurred had the investors retained their own shares. This conclusion seems justified by the importance in a swap fund of a satisfactory selection and rejection of stocks by the managers and investors before the fund begins operating. The funds themselves advertise that they will have a low or minimal portfolio turnover rate.

This type of arrangement differs from a conventional partnership or corporation in which the owners of different assets can pool them tax-free in order to share the risks of conducting an ongoing business. In substance, a swap fund does not conduct an ordinary investment business; instead, it "provides an investment medium consisting of a diversified and supervised portfolio of equity securities to investors holding blocks of individual equity securities with large unrealized appreciation, * * *." [1] If this type of fund can be formed tax-free, it becomes a vehicle geared mainly to diversifying its owners' portfolios while keeping untaxed the appreciation in their original stocks. In effect, each investor tends to be interested chiefly in his own tax needs and in using the fund as his agent for deciding when he will receive direct payment for the gain in the stocks which he originally pooled with other investors.

As a result of these factors the committee believes it is appropriate to view the original exchange of appreciated stocks for shares of a swap fund as a taxable sale or exchange with other investors made through the fund. Thus, the committee's amendment is essentially the same as the provisions of H.R. 11920, with certain modifications as described below.

Explanation of provision

Partnership exchange funds

The committee amendment changes the rule in present law relating to nonrecognition of gain or loss on a contribution of property to a partnership in exchange for an interest in the partnership (sec. 721) by making an exception where a partner transfers property to a partnership which is an "investment company." If the partnership is an investment company after the exchange, the contributing partner must recognize gain (if any) which he realizes on the exchange.[2] The committee amendment thus requires the current taxation of gains realized by investors who transfer appreciated stocks or securities (or other property) to an exchange fund operated as a partnership.

The committee amendment does not change present law with regard to losses, so that a loss realized on a contribution of stock or securities (or other property) to a partnership cannot be recognized at that time.

A partnership will be treated as an "investment company," for purposes of this provision, if it satisfies the definition of an investment company under the present rules relating to corporate exchange funds (sec. 351). The latter rules are set forth in detail in the regulations under section 351. Under these regulations, a partnership will be treated as an investment company if, after the exchange, over 80 percent of the value of its assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities (or interests in regulated investment companies or real estate investment trusts). The determination of whether a partnership

[1] Prospectus of Vance Sanders Exchange Fund (January 5, 1976), p. 1.

[2] Consistent with this rule, a partner's basis for his partnership interest (under sec. 722) is to be increased by the amount of gain recognized on his transfer of property to the partnership. The partnership's basis in the property contributed to it (sec. 723) is also to be increased by the amount of gain which the contributing partner must recognize.

is an investment company under this test will ordinarily be made immediately after the transfers of property under the same plan or as part of the same transaction.

In addition, for nonrecognition treatment to be denied, the transfers of property to the partnership must be found to result, directly or indirectly, in diversification of the transferors' interests.[3] The amount and character of the gain which a partner must recognize under the bill are to be determined under the applicable provisions of present law.[4]

These rules are to apply both to limited partnerships and general partnerships, regardless whether the partnership is privately formed or publicly syndicated. They also require recognition of gain by a person who transfers nonpublicly-traded stocks or securities to a partnership which, after the transfer, meets the tests of an investment company.

As under the corporate rule, the property on which gain will be recognized is not limited to appreciated stocks or securities, but includes other types of property (such as real estate or other assets) if the partnership which receives the property is an investment company after the exchange.

Under the amendment, and except as provided below, a partnership may still be an investment company despite the existence of a special allocation among the partners as to income, gain, loss, or deduction items (sec. 704). In some situations, however, it might be proper to find that no diversification has occurred if the partnership agreement allocates income and gains (or losses) from specific property to the contributing partner and requires that a withdrawing partner be returned the property which he contributed originally.[5]

The amendment will not affect the tax treatment of an investment partnership as a partnership for tax purposes; that is, whether it will be taxable as a partnership or as a corporate-type entity. That classification question will continue to be determined under section 7701 of the Code. An exchange fund which is held to be taxable as a partnership will, however, be subject to the restriction imposed by this bill under section 721 (namely, that transfers of appreciated property to the fund will require recognition of gain if the partnership is otherwise an "investment company").

Family partnerships.—The committee has added an exception to the partnership rules of H.R. 11920, as passed by the House, for certain family partnerships. Where stocks (or other property) are pooled within a single family group, the basic problems against which the

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[3] Since nonrecognition under section 721 of present law does not require that the transferor (either alone or as part of a group of transferors) control the partnership immediately after the exchange, gain on appreciated property will be taxable whether the property is transferred to a partnership already in operation or one which is newly formed.

[4] The committee does not intend this amendment to change existing rules which permit the Service in other situations (apart from those where the partnership operates as an investment company) to treat related contributions and distributions by a partnership having two or more partners as a direct taxable exchange among the partners (regulations § 1.731-1(c)(3)).

[5] The committee believes that the Treasury should provide by regulation (under its broad authority under section 761(a)) that the members of a partnership which would be treated as an investment company are not eligible to make the election under section 761(a) not to be governed by the partnership tax rules. Where a partnership would not be treated as an investment company under the bill, however, because the transfers do not result in diversifying the transferors' interests, the partners should be entitled to make the election under section 761(a) to the extent the election would otherwise be available.

partnership rules in the provision are directed give less reason for concern. The committee has accordingly provided that property can continue to be transferred to a partnership tax free (in exchange for an interest in the partnership) if certain requirements are met. First, the partnership must be a general partnership (rather than a limited partnership). Second, over 95 percent of the total interest in partnership profits and capital must be owned at all times by members of the same family.[6] Third, the partnership agreement must expressly allocate part of the gain recognized on a sale of stocks (or other property) by the partnership to the partner who contributed such stocks or other property to the partnership. The portion of any such gain which must be allocated under this rule is the appreciation in value of the stocks or other property which existed at the date on which that property was first contributed to the partnership. Thus, under this rule a family group may share the income from a pool of stocks so long as each contributing partner in effect bears the tax on the built-in gain which existed at the time he contributed that property to the portfolio.

Effective date.—The amendments for partnership exchange funds apply generally to transfers made to a partnership after February 17, 1976. This general rule applies where the final binding exchange of deposited securities for interests in the fund is consummated after February 17, 1976, and the partnership becomes the owner of the deposited stocks and securities. Except as indicated below, this general rule applies in a situation where stocks or securities were deposited with a depository bank on or before February 17, 1976, but where the actual exchange with the fund occurs after that date.

"*Grandfather*" *rules.*—The committee was informed that several partnership exchange funds were in various stages of being organized or completed when H.R. 11920 was introduced in the House. One fund, the Vance Sanders Exchange Fund, had already obtained a private ruling from the Internal Revenue Service approving formation of the partnership as an exchange fund. By February 17, 1976 (when H.R. 11920 was introduced), other partnerships had taken substantial steps toward establishing an exchange fund by applying for a tax ruling, registering their proposed offering with the Securities and Exchange Commission, lining up brokers and dealer-managers, and soliciting expressions of interest from potential depositors.

The House bill added "grandfather" rules for these funds, under which the general effective date would not apply to completed transfers of property to a partnership after February 17, 1976, if two conditions are satisfied. First, the partnership must have filed for (or received) a private ruling from the Internal Revenue Service on or before February 17, 1976, relating to its character as an exchange fund.[7] Second, the partnership must have filed a registration state-

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[6] For this purpose, a family includes an individual general partner and other general partners who are parents, grandparents, brothers, or sisters of that individual, or lineal descendants, a spouse, or an estate of any member of that group. In determining family members, any individual partner may be selected and the family members may then be determined by reference to that individual. If sufficient relationships exist with respect to any one partner, the family ownership requirement has been satisfied even though those relationships do not exist with respect to any other partner.

[7] A ruling from the Service received before February 17, 1976, relating to the basic classification of a partnership under section 7701 of the Code is not sufficient. To qualify, the ruling must have been based on the partnership's plan to operate as an investment company (within the meaning of that term in this bill's partnership provisions) and the ruling must have held that nonrecognition treatment can be obtained under section 721 of present law.

ment (if required by the securities laws to do so) with the Securities and Exchange Commission on or before February 17, 1976. This second requirement would not apply in the case of partnerships which plan to make a private offering within the meaning of the securities laws or which otherwise are not required to file a registration statement with the SEC.

The committee has been informed that several other exchange funds had also taken significant steps toward being formed before the February 17 date contained in the House bill, but, at that time, had not filed a tax ruling request or a registration statement with the Securities and Exchange Commission. The committee was informed that the reason was that there was a great deal of uncertainty over the status of the law, and informal contacts with Internal Revenue Service personnel indicated that the rulings would not be acted on until the Service's position in this area was clarified. As a result, these funds did not file their ruling requests or registration statements by February 17, 1976, although they had expended considerable sums of money and time in preparing for the organization of their fund, having been aware of the previous private ruling issued to the Vance Sanders Fund. The committee believes it is appropriate to extend the date provided in the House bill until the time the House Committee on Ways and Means held hearings on its bill. Accordingly, the committee amendment extends the cutoff date under the grandfather rules to March 26, 1976. A partnership which submitted a ruling request with the Internal Revenue Service on or before March 26, 1976, to operate an exchange fund as a general partnership will also be included within the extended transition rule if after the March 26 date and because of securities difficulties, it changes to a limited partnership similar to that used by other partnership exchange funds.

In addition, the committee does not believe that it is necessary to provide dual conditions for grandfather treatment. As a result, the committee's amendment imposes conditions in the alternative, so that a fund can qualify for grandfather treatment if it either filed a ruling request with the Service or a registration statement with the Securities and Exchange Commission before March 27, 1976. Other limitations contained in H.R. 11920, as passed by the House, were agreed to by the committee and will apply equally to the additional funds included in the grandfather provisions. These rules are set forth below.

A partnership qualifying for grandfather treatment must satisfy certain other limitations. First, there is a limit on the time period for the exchange. The final binding exchanges of deposited stocks or securities for interests in the partnership must occur in any event on or before the 90th day after the date on which the provision becomes law. (Exchanges under this rule may be consummated before the date of enactment of the provision, but qualifying exchanges must be completed no later than the end of the 90th day after enactment.) The stocks or securities exchanged must also have been deposited with the bank or other agent of the depositors on or before the 60th day after the date on which the bill is enacted.

The provision also places a dollar limit on the total size of the grandfathered funds. If stocks or securities had been deposited by February 29, 1976, the partnership may complete exchanges with investors of the entire dollar value of securities on deposit by that date (or a lesser sum if securities are withdrawn or rejected after the end of the deposit period). In the case of other funds which had not begun receiving deposits by February 29, 1976, the provision permits qualifying partnerships to make exchanges with depositors in the amount of the total dollar value of the deposited stocks on the 60th day after the provision becomes law (or if earlier, at the close of the fund's initial deposit period), up to a ceiling of $100 million ($25 million in the case of a private offering). These valuation ceilings will be determined on this 60th day (or, if earlier, on the last day of the fund's initial deposit period).

Trusts

In order to cover the possible use in the future of trusts as exchange funds, the amendment also adds a specific rule to the Code that gain (but not loss) will be recognized to the transferor on a transfer of property to a trust in exchange for an interest in other trust property where the trust would be an "investment company" (within the meaning of sec. 351) if the trust were a corporation. Under the committee amendment, an "exchange for an interest in other trust property" will occur, for example, where numerous persons transfer property to a trust and each person retains a proportionate ownership in all of the property held in the trust. Where a transfer to a trust is taxable under the amendment, the entire amount of gain on all the property transferred to the trust is to be recognized even though the transferor still beneficially owns a portion of the property transferred to the trust. Where the transferor retains less than his proportionate interest in the trust, it is expected that the Service will issue regulations determining when gain must be recognized and the amount of gain to be recognized by the transferor.

Where a transfer to a trust is taxable under the amendment, the determination of the amount of gain to be recognized is to be made on a property-by-property basis. Thus, losses realized on one property are not to reduce the amount of gain recognized under this provision on other property transferred to the trust.

The provisions of the amendment apply only to trusts which are subject to the rules governing normal trusts (subpart J of chapter 1 of the Code). Consequently, the amendment does not apply to qualified employee benefit trusts or charitable and other tax-exempt organizations which are organized as trusts (i.e., those trusts which are subject to subchapters D and F of chapter 1 of the Code).

In addition, the amendment contains an exception from the above trust rules for transfers to a pooled income fund (as defined in section 642(c)(5)).

Effective date.—The provisions relating to trusts are effective for transfers made after April 7, 1976.

Common trust funds

The committee is also concerned about the use of a bank's common trust fund as an exchange fund. To cover this case, the amendment provides that the admission of a participant to a common trust fund is to be considered to be the purchase of, or an exchange for, the participating interest in the fund. Where the consideration for the participating interest is cash, the transaction will be considered a purchase of a participating interest. In such a case, the participant will not recognize any gain because there has not been a sale or other disposition of property.[8]

Where the consideration for the participating interest is property, the transaction will be considered an "exchange" of the property for the participating interest. As a result, gain or loss will be realized under section 1001 by the participant on any transfer of property to the common trust fund. This gain or loss must ordinarily be recognized to the participant (sec. 1002) and, if the property transferred is a capital asset, the gain or loss will be a capital gain or loss.

The committee understands that the House bill, in this area, was based on the policy of the Comptroller of the Currency, who regulates these funds (which are maintained by banks). The Comptroller generally requires that if an individual trust wants to join an existing common trust fund, appreciated stocks or similar securities owned by the trust must first be sold (sometimes to the common trust fund itself) and only the sale proceeds contributed to the common trust fund. However, where a common trust fund is being formed initially, the Comptroller has on occasion permitted participants to transfer stocks or securities in kind to the fund. The amendment will not affect transfers of cash to a common trust fund. The amendment will require recognition of gain, however, where the Comptroller permits a common trust fund to be created by contributions in kind, if the effect is to achieve a diversification of the transferors' investment interests.

The committee also understands that in some situations when banks merge or otherwise reorganize with each other, the combining banks have also merged (and sometimes also divided) separate common trust funds formerly maintained by each bank. The committee has also been informed that the Comptroller of the Currency requires a common trust fund to maintain a diversified portfolio which would readily satisfy the diversification test in H.R. 11920 for corporate investment companies (as described below).

Since the amendment permits a merger of corporate investment companies to continue to receive tax-free treatment if both companies are already diversified (see discussion below), the committee believes that a similar rule is implicit in the bill for common trust funds; namely, that mergers (or divisions) of common trust funds regulated by the Comptroller of the Currency are also to continue to be eligible for tax-free treatment if all the combining (or dividing) funds have diversified portfolios (within the meaning of the corporate merger rules of H.R. 11920 and of the committee's amendment).[9]

Effective date.—The amendment to the common trust fund rules is effective for transfers made after April 7, 1976.

Mergers of two or more investment companies

The amendment (like the House bill) adds an exception to the definition of a taxfree "reorganization" in present law in order to require recognition of gain or loss on exchanges which, from an in-

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[8] Under section 1001, gain or loss is realized on the sale or other disposition of property.

[9] If diversified funds are merging (or dividing), the committee's amendment thus does not intend to treat the participating trusts or the separate funds as being "admitted" to the surviving (or divided) fund in order to make the merger or division taxable under the amendment.

vestor's standpoint, resemble the formation of an exchange fund. This exception is provided in specific terms in order not to change the application of the reorganization rules to transactions other than those which enable investors to obtain the primary advantages of an exchange fund (namely, carryover of a low tax basis to the fund, untaxed appreciation to the investor and tax-free diversification of his investment assets). The amendment makes taxable a statutory merger or other exchange of assets or stock with respect to an undiversified investment company (as specifically defined in the amendment) if the result of the exchange is to achieve significantly more diversity for the shareholders of that company than existed before the exchange. The amendment continues to allow nonrecognition treatment generally for reorganizations. Also, if two or more investment companies (or their shareholders) participate in an exchange with each other, the transaction will continue to be eligible for tax-free reorganization treatment if both companies have diversified portfolios before the exchange.

More specifically, the amendment provides that if the parties to an exchange otherwise described in the tax-free reorganization provisions (under sec. 368(a)(1)) include two or more "investment companies," the exchange will not qualify for customary reorganization treatment as to one or more of the investment companies and their shareholders and security holders if that company owned a relatively undiversified portfolio of stock or securities before the exchange.

This rule will disqualify only the portion of the entire transaction involving the undiversified investment company and its shareholders and security holders.[10] For example, if two undiversified investment companies and a corporation predominately engaged in an active business combine in a statutory consolidation, the amendment will in effect treat each acquired investment company as if it had sold its assets in a taxable transaction, i.e., one in which gain or loss is recognized currently.[11] In most situations, this rule will also treat each shareholder of each undiversified investment company as if he had made a taxable exchange of his former stock interest for stock in the acquiring company.[12] The merger of the operating company's assets under the same plan, however, could qualify under the customary reorganization rules.

Definition of "investment company."—The amendment defines an investment company (for purposes of the reorganization rule) as (1) a regulated investment company, (2) a real estate investment trust, or (3) a corporation over 50 percent of the value of whose total assets consist of stocks or securities and, in addition, over 80 percent of the value of whose total assets are held for investment. Investment assets

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[10] The acquiring company will also not be entitled to the usual carryover basis and carryover of tax items under section 381 of present law with regard to the portion of the transaction which (under the amendment) is denied nonrecognition status.

[11] The amendment takes no position on the question whether the provisions of section 337 are available to the acquired company where a transfer of its assets fails to qualify for nonrecognition treatment under section 361. Section 337 provides nonrecognition treatment to a corporation which sells its assets and liquidates completely within 12 months after adopting a plan of complete liquidation. The possible application of section 337 is to be determined under existing law.

[12] Where a shareholder of an undiversified investment company exchanges his stock solely for voting stock of another investment company in an exchange otherwise described in sec. 368(a)(1)(B), the effect of disqualifying that exchange for tax-free treatment will be to treat the shareholder of the undiversified investment company as having sold his stock in a taxable exchange.

in the 80-percent category include stocks or securities as well as other kinds of property held for investment purposes.[13] A company which fits within any of the above three classes is regarded as an investment company for purposes of the reorganization rule of the amendment.[14]

The committee believes it is important to distinguish for this purpose between corporations whose ownership of stock involves relatively passive management of portfolio assets as an investment and holding companies (including so-called conglomerates) which render management services to operating business companies in which it (the parent) usually owns the controlling stock. Thus, the amendment provides that in applying the 50-percent and 80-percent asset tests (to determine whether a corporation is an "investment company"), a corporation will be deemed to own directly its ratable share of the assets of a subsidiary corporation in which the parent owns 50 percent or more of the combined voting power of all voting stock of the subsidiary or 50 percent or more of the total value of all classes of the subsidiary's outstanding stock.[15]

In determining a corporation's "total assets" under the 50-percent and 80-percent tests, cash and cash items (including receivables) are to be excluded from the calculation. U.S. Government securities are also to be excluded from both the numerator and denominator in this calculation. The amendment contains a further rule aimed at preventing manipulation of a company's assets in order to make one or more of the parties not an "investment company" (and therefore free of the amendment's restrictions). The amendment provides that assets acquired by a corporation for purposes of causing that corporation not to be an "investment company" are to be disregarded in determining whether that corporation is an investment company immediately before the transaction. This rule is not intended to affect situations where a corporation purchases or otherwise acquires portfolio stocks or securities in the ordinary course of conducting its activities (such as buying or selling in response to trends in the stock market). This rule is intended, however, to affect situations where a major pur-

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[13] The committee believes that the types of investment assets which should be treated as "securities" for this purpose include obligations of State and local governments (including industrial development bonds), stock warrants, stock options and rights, commodity futures, mutual fund shares (both open and closed end), interests in real estate investment trusts, commercial paper, corporate notes (whether or not secured by an inteerest in real property), participating interests in Federally guaranteed or insured mortgage or other loan pools, and interests in partnerships the sale of which are required to be registered with the Securities and Exchange Commission or State securities offices.

The types of stocks and securities to be taken into account under this third category of investment company include closely held and publicly traded investments (i.e., the latter covering stocks traded on a stock exchange or over-the-counter, or which are otherwise readily marketable).

[14] An investment company for this purpose does not have to be technically a "personal holding company" within the meaning of section 542 of present law. The nature of the stockholders of the investment company is also immaterial in applying these rules.

[15] To illustrate, suppose that all the assets of holding company *X* consist of directly-owned investment assets of $30,000; small amounts of stock in publicly held company *A* worth $30,000 and in public company *B* worth $25,000; and over 50 percent of the stock of operating company *C* to which *X* provides management services. The value of *X*'s stock in *C* is $15,000, reflecting its allocable share of *C*'s net assets. *C* owns no investment assets. The value of *X*'s ratable share of *C*'s "total assets" (not reduced by liabilities) is $70,000.

Under the amendment, since *X* owns 50 percent or more of *C*, *X* will be deemed to own $70,000 of *C*'s total assets directly. As such, *X* will not be an investment company since less than half of its total assets will be deemed invested in portfolio stocks ($55,000/$155,000). Also, less than 80 percent of *X*'s total assets will be treated as held for investment ($85,000/$155,000).

If there were no look-through rule of this kind, *X* would be treated as an investment company because more than 50 percent of its total assets would consist of stocks ($55,000/$100,000) and over 80 percent of its total assets would be held for investment purposes.

pose of an asset acquisition is specifically to circumvent the limitations under this provision, so that a reorganization involving that corporation can subsequently occur and escape the tax treatment which this amendment would impose if the company's assets had not been manipulated in this fashion. It is expected that specific rules for tax avoidance situations of this kind will be prescribed by the Internal Revenue Service.

Diversification test.—A company meeting the definition of an "investment company" is considered to have an undiversified portfolio unless it is (1) a regulated investment company, (2) a real estate investment trust, or (3) a corporation not more than 25 percent of whose total assets (by value) are invested in the stock or securities of any one company and not more than 50 percent of whose total assets (by value) are invested in the stock or securities of 5 or fewer companies.[16] In applying the third of these classes, an investment company which fails either one or both requirements is to be considered undiversified. As such, a reorganization of that corporation may be subject to tax, depending on the other parties to the transaction.

The amendment also delegates authority to the Service to disregard active business assets or other properties which an investment company deliberately acquires before a planned reorganization for the purpose of qualifying the company as diversified under the above tests.[17]

Other provisions.—The specific reorganizations to which the above rules will apply are the five exchanges listed in section 368(a)(1)(A), (B), (C), (D), and (F).[18]

The amendment makes an express exception to the denial of tax-free reorganization treatment where two or more investment companies are owned substantially by the same persons in the same proportions. In these cases the shareholders and security holders of the companies

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[16] For purposes of this rule, stock or securities are to have the same meaning as they have in defining an investment company under this reorganization rule. In addition, the stock of all members of a controlled group of corporations (as defined in section 1563(a) of the Code) are to be treated as the stock of a single company.

A look-through rule similar to the rule used in defining an "investment company" is also used in determining whether an investment company is diversified. In the example set forth in footnote 15, *X* would be deemed to own $70,000 of *C*'s assets directly. As such, *X* would be considered diversified because neither stock *A* nor stock *B* would be valued at over 25 percent of *X*'s total assets ($155,000), and the combined value of the two portfolio stocks (*A* and *B*) would not be greater than half the value of all of *X*'s total assets ($155,000). Without this look-through rule, the value of *X*'s stock in *A* would exceed 25 percent of *X's* total assets ($30,000/$100,000) and the amendment would treat *X* as undiversified.

[17] Assume, for example, that the only assets owned by Corporation *X* are appreciated stock in listed company *Y* worth $100,000 and appreciated real estate worth $75,000. In a deliberate attempt to satisfy the diversification test, *X* borrows $225,000 and purchases stock in nine other listed companies for $25,000 each. *X* would then satisfy the diversification test because no more than 25 percent of its total assets (i.e., no more than $100,000 of $400,000) would be invested in the stock of one issuer, and no combination of five or fewer stocks would amount to over 50 percent of the value of *X*'s total assets (i.e., would amount to over $200,000).

Under the tax-avoidance rule, however, the stock in the nine corporations purchased by *X* solely to satisfy the diversification test is to be disregarded in determining whether *X* is diversified. As a result, *X* would not meet the diversification test because more than 25 percent of its total assets (i.e., $100,000 of total assets of $175,000, disregarding the stock in the nine corporations) would be invested in one issuer (company *Y*).

The intended scope of the authority delegated to the Service under the diversification test is identical to the scope of the authority delegated to the Service in determining whether a corporation is an investment company for purposes of this amendment (see the earlier discussion of the latter delegation).

[18] The amendment does not include a recapitalization (sec. 368(a)(1)(E)) in this list because a recapitalization involves only one corporation, and although various tax-free changes are permitted to be made in an existing shareholder's rights in the same corporation (such as changes in voting rights and changes from debt to equity interests), this does not produce the kind of diversification in investors' interests which resembles the tax-free formation of an exchange fund.

being combined ordinarily will not diversify their stock investments after the transaction; the bill accordingly permits reorganizations of commonly controlled investment companies to continue to be tax-free. It is expected that the Service will set forth by regulation the detailed rules needed to carry out the purposes of this exception.[19]

Since a denial of tax-free reorganization status adversely affects the acquired company (and its shareholders) but does not require recognition of gain or loss by the acquiring company (or its shareholders), the amendment contains a rule to cover what is, in effect, a "reverse acquisition." This rule is designed to assure that regardless of whether an investment company is, in form, the acquired or acquiring party, tax-free reorganization treatment will be denied only for the portion of the exchange involving an undiversified investment company (and its shareholders and security holders). If two or more undiversified investment companies combine with each other, the committee believes that gain should be recognized by both companies (and by their shareholders and security holders as appropriate) rather than solely by the company which is formally acquired by the other. Otherwise, an undiversified investment company which is the acquiring company will obtain tax-free diversification. The amendment, therefore, provides that, for purposes of gain or loss recognition, the corporation (and its shareholders and security holders) which is the acquiring or surviving party is to be considered as having been acquired by the other party in an exchange which must itself be tested under the general rule of the amendment.

For example, if an undiversified investment company acquires the assets of a diversified investment company in a statutory merger or a "C" reorganization, the amendment will not prevent the acquired company or its shareholders from qualifying for reorganization treatment under present law (since that company is an already-diversified investment company). However, for purposes of determining recognition of gain or loss, the amendment treats the acquiring company and its shareholders (and security holders) as having been acquired by the other company in a statutory merger or "C" reorganization. Since nonrecognition treatment will be denied on such a constructive exchange, the undiversified company is to be treated as if it had exchanged its assets in a taxable exchange for stock of the diversified company and then had distributed that stock to its own shareholders and security holders in exchange for their stock in the undiversified company.

If two undiversified investment companies merge with each other, the general rule of the amendment denies reorganization status to the acquired company and its shareholders. For purposes of recog-

[19] Under this delegation, it is anticipated that the Service will provide a rule that if common control over two or more corporations is obtained for the specific purpose of bringing a later reorganization under this exception, the exception will not be available. (A similar rule is contained in section 1.382(b)-1(d)(3) of the Income Tax Regulations under section 382 of present law).

Several courts have held that a combination of two or more commonly owned operating corporations may qualify as an "F" reorganization (sec. 368(a)(1)(F)). The Service has accepted this treatment if several conditions are satisfied, including a complete identity of shareholders and their proprietary interests in the transferor and acquiring corporations (Rev. Rul. 75-561, 1975-2 C.B. 129). The committee does not intend the changes made by this amendment to affect, one way or the other, the question of whether an "F" reorganization can occur where two or more corporations are combined or, if so, whether an "F" reorganization can occur if complete identity of ownership does not exist.

nizing gain or loss, the special "reverse acquisition" rule will also test the company which is formally the acquiring company as though that company and its shareholders had been the acquired parties. As a result, that company (and its shareholders) will be considered to have made an exchange and, since the exchange will be considered made with another undiversified investment company, the special rule will deny nonrecognition treatment to that constructive exchange (and treat that company as having made a taxable exchange).[20]

Under these rules, the amendment will not change the tax-free treatment available under present law where one or more regulated investment companies or real estate investment trusts merge (or otherwise reorganize) with each other. The amendment also will not affect mergers solely involving active business companies which are not "investment companies" (as defined in the amendment). Nor will the new rules prevent a tax-free merger solely of one undiversified investment company with an active business company (which is not an investment company).

Effective date

These reorganization rules apply to exchanges consummated after February 17, 1976. The amendment makes an exception for exchanges occurring after February 17, 1976, pursuant to a private tax ruling issued by the Internal Revenue Service before February 18, 1976. The tax ruling must have held that the proposed reorganization will qualify as a reorganization under sec. 368(a)(1) of present law.

Revenue effect

It is estimated that these provisions will increase budget receipts by less than $5 million in fiscal years 1977 and 1978 and increase budget receipts by $12 million in fiscal year 1981.

11. Distributions by Subchapter S Corporations (sec. 2311 of the bill and sec. 1377 of the Code)

Present law

Under present law, the shareholders of a subchapter S corporation are taxed each year on the income of the corporation, regardless of whether this income is distributed currently as dividends to the shareholders. If the shareholders of a subchapter S corporation have been taxed on income of the corporation which has not been distributed to them, the corporation in a subsequent year can distribute this previously taxed income without the shareholders incurring any additional tax liability. However, before a distribution will constitute a distribution of previously taxed income, the corporation must first have distributed an amount equal to its current earnings and profits in the year of such distribution.

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[20] Where an undiversified investment company acquires the stock of another corporation in an exchange described in section 368(a)(1)(B), the shareholders of the acquiring company may be treated as having made a taxable exchange. The shareholders will be treated as having exchanged their stock for stock of the other corporation; thus, that constructive exchange is then to be tested under the general reorganization rule in the amendment. If, under that test, the constructive exchange does not qualify for nonrecognition treatment (because, for example, the other corporation is also an undiversified investment company), the shareholders are to be required to recognize gain in the difference between the basis of their stock in their own company and the value of a percentage of the other corporation's stock equal to the percentage of the stock in their own company which they retain after the actual "B" exchange which in fact occurred.

Present law (sec. 312(m), enacted in 1969) requires generally that the earnings and profits of corporations, including subchapter S corporations, be computed using straight line depreciation, rather than the accelerated depreciation methods taxpayers may use for computing taxable income. Thus, where a corporation elects an accelerated depreciation method, this provision causes the earnings and profits of the corporation to be greater than its taxable income. In the case of a subchapter S corporation, however, special earnings and profits rules are provided (sec. 1377) to prevent earnings and profits of a subchapter S corporation from being less than its taxable income.

Reasons for change

In tax years where a subchapter S corporation has claimed an accelerated depreciation deduction which exceeds the amount allowable under the straight line method, the corporation will have current earnings and profits which exceed its taxable income. If the corporation makes cash distributions for that year in amounts in excess of its current taxable income (which is taxed to the shareholders, whether distributed or not), the excess distributions will also be considered dividend income to the stockholders to the extent that the corporation's current earnings and profits exceed its taxable income. This will occur even though the corporation has undistributed taxable income which has previously been taxed to the shareholders. The committee believes that this unintended interplay between the subchapter S rules and section 312(m) should be changed so that a corporation can distribute previously taxed income to the extent its distributions exceed its taxable income even though, as a result of section 312(m), its current earnings and profits exceed its taxable income.

Explanation of provision

Under the committee's amendment, current year earnings and profits are to be computed without regard to section 312(m) solely for purposes of determining whether a distribution by a subchapter S corporation is considered to come from the corporation's previously taxed income or from its current earnings and profits. As a result, where the current earnings and profits of a subchapter S corporation exceed its taxable income because of section 312(m) for a year when it makes a cash distribution in excess of its taxable income, that excess will, to the extent of its undistributed previously taxed income, be considered to be a distribution of this previously taxed income. Consequently, it will not be taxable to the shareholders and will not reduce earnings and profits of the corporation. If the distribution exceeds the sum of the previously taxed income and the taxable income in the year of distribution, the excess will be considered a taxable dividend to the extent of the current and accumulated earnings and profits, in accordance with the rules generally applicable to corporations. Accordingly, any such excess distribution would be taxable as a dividend to the extent of current earnings and profits (determined with regard to section 312(m)) even though the corporation had a deficit in accumulated earnings and profits.

For example, assume a subchapter S corporation has $100 of taxable income, $120 of current earnings and profits (the $20 difference between taxable income and current earnings and profits representing the accelerated portion of depreciation which is not taken into account for purposes of current earnings and profits as a result of section 312(m)), and $10 of undistributed taxable income previously taxed to shareholders in a prior year. Assume further that in such year the corporation distributes $120 to its shareholders. Under the committee's amendment, solely for purposes of determining whether the corporation has distributed previously taxed income, the corporation's current earnings and profits are considered to be $100. Accordingly, $10 of the amount distributed is treated as a distribution of previously taxed income and is received without additional tax liability by the shareholders, and $110 of the amount is treated as a distribution of current earnings and profits and is taxed to the shareholders as a dividend. The remaining $10 of undistributed current earnings and profits increases accumulated earnings and profits. The results of the above example would be the same even if the corporation had a deficit in accumulated earnings and profits.

Present law (sec. 1375) gives the Treasury Department discretion to prescribe regulations relating to the distribution of previously taxed income. The committee recognizes that various aspects of the regulations promulgated thereunder (for example, those which describe the consequences of an election to treat distributions as not constituting distributions of previously taxed income) will have to be modified to conform to and reflect the committee's amendment.

There is no comparable provision in the House bill.

Effective date

This amendment applies to taxable years beginning after December 31, 1975.

Revenue effect

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

C. TITLE XXIV—INTERNATIONAL TRADE COMMISSION AMENDMENTS

(secs. 2401–2406 of the bill)

The Committee on Finance reports favorably an amendment authorizing appropriations to the U.S. International Trade Commission for fiscal years 1977 and 1978 and making changes in the organization and procedures of the Commission. The committee recommends the adoption of the amendment.

1. Background and Summary

This committee amendment adds a new title to H.R. 10612 relating to the operation of the U.S. International Trade Commission (formerly the "Tariff Commission" and hereinafter referred to as the "Commission"). Section 2401 denominates the amendment as "The International Trade Commission Act of 1976." Section 2402 amends the Tariff Act of 1930, with respect to the voting procedures of the Commission in import relief cases. Section 2403 amends the Tariff Act of 1930 with respect to the size of the Commission, increasing its membership from six to seven Commissioners. Section 2404 authorizes appropriations to the Commission for fiscal years 1977 and 1978. Section 2404 also restricts the number of personal staff which may be employed by the Chairman of the Commission and each of the Commissioners. Section 2405 amends the Tariff Act of 1930 with respect to the selection of the Chairman of the Commission and the administrative authority of the Chairman. Section 2406 directs the Commission to continue through 1980 certain reports on the production and trade of synthetic organic chemicals.

To accommodate the House of Representatives and for purposes of conference, the committee's amendment contains sections 2 and 3 of H.R. 13396 (H. Rept. 94–1088), which has been reported by the Committee on Ways and Means and passed by the House on May 19, 1976. The committee's amendment deletes section 1 of the House bill, the authorization of appropriations, and replaces it with the authorization of appropriations passed by the Senate on May 15, 1976, in S. 3420 (S. Rept. 94–818), which is a greater amount. In addition, the committee's amendment contains certain other provisions relating to the organization and administration of the Commission which differ from the provisions of the House bill. For this reason, certain provisions of sections 2403, 2404, and 2405 of the committee amendment are inconsistent.

The committee reported S. 3420, authorizing appropriations to the Commission for fiscal years 1977 and 1978 on May 12, 1976, and the Senate adopted the bill on May 15, 1976. The committee amendment, therefore, is consistent with the policy of Section 402 (a) of the Congressional Budget Act of 1974 (Public Law 93–344) with respect to the required reporting dates for authorizing legislation. Furthermore, because the committee amendment is a floor amendment and not a reported bill, the committee amendment is in technical compliance with section 402(a) of the Budget Act.

2. Section-by-Section Explanation of the Committee Amendment

Section 2401

This section provides that the amendment may be cited as "The International Trade Commission Act of 1976."

Section 2402

This section amends section 330(d) of the Tariff Act of 1930, relating to the voting procedures of the Commissioners in import relief cases. The committee states that nothing contained in this section, or in any other provision of the amendment, is intended to alter the eligibility criteria for import relief under the Trade Act of 1974. In addition, the committee states that nothing contained in this section, or in any other provision of the amendment, is intended to affect retroactively any decision previously reached by the Commission with respect to any petition for import relief. In addition, the committee states that nothing contained in this section, or in any other provision of the amendment, is intended to change the legal authority of the President under present law to select the type and level of import relief to be provided to an industry, be it the form of relief recommended by the Commission, a modification of the Commission's recommendation, or a denial of relief altogether.

Congress, in the Trade Act of 1974, amended the trade laws of the United States and modified the provisions of law under which temporary import relief is afforded domestic industries incurring serious injury (or threat thereof) from increased imports (the "escape clause"). Sections 201, 202, and 203 of the 1974 Trade Act were intended by Congress to improve procedures for providing temporary relief for industries incurring serious injury (or threat of serious injury) from increased imports. Under these provisions, domestic industries may be entitled to temporary import relief if they can show to the satisfaction of the Commission that increased imports are a substantial cause of serious injury, or the threat thereof, to the domestic industry producing a like or directly competitive article. If the Commission determines that a petitioner is entitled to import relief (the "injury determination"), it next considers the question of what form of relief it will recommend to the President (the "remedy determination"), and transmits this remedy determination to the President along with the injury determination. Upon receiving the determinations of the Commission, the President has sixty days in which to determine what form of import relief, if any, or of adjustment assistance, he will provide. The President in effect has three options: (1) He may implement the remedy recommended by a majority of the Commission; (2) he may implement a remedy other than the recommendation of the Commission; or (3) he may deny relief if he determines that relief would not be in the national economic interest. Under the Trade Act of 1974, if the Congress prefers the remedy recommended by the Commission rather than the relief proposed by the President, or if the President declines to grant relief, a majority of those present and voting of both Houses may pass a resolution within 90 Congressional working days requiring the President to implement the remedy recommended by the Commission.

This was the manner in which the Trade Act was intended to work. However, in two of the six escape clause cases under the Trade Act in which the Commission found by a majority vote that injury existed, the Commission was unable to reach majority agreement with respect to a remedy. In such cases, even though a majority of the Commission agree that an industry is being injured, because the Commission cannot agree as to what kind of relief is appropriate, the Congressional override mechanism of the Trade Act fails to function. When the Commissioners are unable to reach, through compromise, a common position with respect to remedy, the Congress is deprived of its opportunity to override the decision of the President and to reinstate the recommendation of the Commission. In such a situation, the President is free to deny import relief—for reasons which may be rooted in foreign policy without adequate regard to sound economics—without fear of being overridden by the Congress. The result is that an industry which may be found by the Commission to be entitled to import relief has been deprived of that relief, without good reason.

The Committee's amendment would increase the probability that if there is a majority vote for injury, there would be a majority finding on a remedy. The Committee's amendment would:

(1) Change the number of Commissioners from six to seven (see section 2403);

(2) Permit only those Commissioners who vote for injury to vote for a remedy;

(3) Require that a recommendation by a plurality of the number of Commissioners voting for remedy be considered the Commission's recommendation for import relief;

(4) Require that a recommendation by any group of Commissioners voting for remedy be considered the Commission's recommendation for import relief if the Commissioners are divided into two or more equal groups; and

(5) Provide that a Commissioner whose term has expired may continue in office until his successor has been nominated by the President and confirmed by the Senate (see section 2403).

Section 2403

The committee agreed to increase the number of Commissioners from six to seven. The committee wishes to retain the expiration dates and the periods of chairmanship and vice chairmanship of sitting Commissioners as they are under current law. Prospectively, Commissioners will serve eight years and nine months, with fifteen-month periods as Chairman and Vice Chairman. In order to accommodate these changes with the immediate appointment of a seventh Commissioner and the immediate successors of sitting Commissioners, Commissioners will have varying terms during a transitional period, through June 1984. The Commissioner who is appointed to office for the term which begins on September 17, 1985, and all Commissioners subsequently appointed will serve terms of eight years and nine months. The new, seventh, Commissioner will be the first to serve a fifteen-month chairmanship, during the last fifteen months of his term, which expires on September 16, 1985. Beginning with the new, seventh, Commissioner's chairmanship and thereafter, the vice-chairmanship will also be for a fifteen-month period, beginning thirty months before the expiration of each Commissioner's term.

In the past, there has often been a delay between the time of the expiration of a Commissioner's term and the taking of office of his successor. Because any such periods of delay would leave the Commission without an odd number of Commissioners and, therefore, without a tie-breaker, the Committee's amendment would continue in office the Commissioner whose term has expired until his successor is confirmed by the Senate and takes office.

Section 2404

The committee amendment contains the authorization of appropriations to the Commission for fiscal years 1977 and 1978 as passed by the Senate in S. 3420 on May 15, 1976. The committee, as in its original bill, has authorized the appropriation to the Commission of specific amounts necessary to carry out its duties and functions during fiscal year 1977 and fiscal year 1978. Section 330(e) of the Tariff Act of 1930 (19 U.S.C. 665), as amended by section 175(b) of the Trade Act of 1974, requires Congress to enact an authorization of appropriations to the Commission for each fiscal year beginning with fiscal year 1977. The committee believes that an orderly budgeting and planning process by the Commission will be facilitated if this amendment, the first budget authorization to be considered by Congress pursuant to section 330(e), as amended, authorizes appropriations for both fiscal year 1977, beginning October 1, 1976, and fiscal year 1978, beginning October 1, 1977. The result of this approach will be that the Congress will enact a 1-year authorization every calendar year, beginning in 1977, but the authorization will be for the fiscal year which begins approximately 1 calendar year after the authorizing legislation is enacted. This schedule, the Committee believes, will enable the Commission to establish long range financial planning. It will also enable the Commission to plan long term projects based upon specific information about future appropriations.

The committee amendment authorizes the appropriation of $11,789,000 to the Commission for fiscal year 1977. This represents the full amount included in the President's budget message to the Congress—$11,539,000, plus an additional $250,000 requested by the Commission for rental of new office space if, as seems likely, it is forced to vacate its deteriorating building.

The basic Commission authorization for fiscal year 1977 ($11,539,000) represents a dollar increase of $1,139,000 over the estimated fiscal year 1976 appropriation of $10,400,000. Of this increase in the Commission budget request, $1,089,000 results from cost-of-living increases in compensation required by law, increased postal rates, and other unavoidable cost increases.

The basic Commission authorization request for fiscal year 1977 contemplates a staff of 426 full-time permanent employees. This is four fewer staff members than the 430-member staff budgeted for fiscal year 1976. It should be noted, however, that the Commission is presently operating with approximately 45 staff vacancies.

The committee believes the increase in the ITC budget request is justified by the increased workload imposed on the Commission under the Trade Act of 1974. This increased workload is demonstrated in the following table:

ACTUAL AND ESTIMATED MAN-YEAR REQUIREMENTS, FISCAL YEAR 1974 THROUGH FISCAL YEAR 1977

Activities	Actual man-years		Estimated man-years	
	1974	1975	1976	1977
ACTIVITY 1				
A. Public investigations:				
1. Import injury (TEA of 1962 and secs. 201 and 406 of TA of 1974)	27	22	42	55
2. Under sec. 332 of the Tariff Act of 1930:				
(a) Pursuant to Presidential request	71	28	18	25
(b) Pursuant to congressional resolution	13	2	30	35
(c) Initiated on the Commission's own motion, and special studies	2	5	9	16
3. Interference with agricultural programs (AAA)	9		1	1
4. Antidumping (Antidumping Act, 1921)	21	9	15	15
5. Unfair practices:				
(a) Sec. 337 of TA of 1930, as amended	18	25	37	40
(b) Sec. 303 of TA of 1930, as amended (counter-vailing duty)			1	1
(c) Sec. 301(c) of TA of 1974 (export subsidy)			1	1
(d) Sec. 301(e) of TA of 1974 (foreign import restrictions)			1	1
6. Probable economic effect of concessions (TA of 1974)	17	113	20	10
7. East-West trade reports (sec. 410 of TA of of 1974)		2	2	3
Total public investigations	178	206	177	203
B. Furnishing technical information and assistance to:				
1. Congress	10	8	10	10
2. Federal agencies	2	2	2	2
3. Public	7	8	10	10
Total furnishing technical information and assistance	19	18	22	22
C. Other reports and activities:				
1. Relating to trade agreements	12	15	25	30
2. Synthetic organic chemicals reports	16	14	14	
3. Summaries of trade and tariff information	1		15	25
4. Statistical enumeration, code structure and publication	7	12	38	30
Total other reports and activities	36	41	92	85
D. Assembling and analyzing economic and technical information	44	46	50	55
Activity 1, total	277	311	341	365
ACTIVITY 2				
Executive direction and administration:				
A. Commissioners' offices	21	23	28	33
B. Administration	30	39	42	43
Activity 2, total	51	62	70	76
Grand total	328	373	411	441
Less overtime equivalent and excess day	−3	−5	−5	−4
Net reportable man-years (per OMB Circular A-11)	325	368	406	437

This section also authorizes appropriations of $12,036,000 for fiscal year 1978, beginning October 1, 1977. This is the amount requested by the Commission. It reflects an increase of 2 percent over the authorization for fiscal year 1977. This increase is based on an estimate of the cost of providing continuing services adjusted by known cost increases. The committee believes the rate of increase in workload from fiscal year 1976 to fiscal year 1977 caused by the enactment of the Trade Act of 1974 will not be continued after fiscal year 1977. Further, this section authorizes additional appropriations for fiscal years 1977 and 1978 which are necessary to pay legally required cost-of-living increases in compensation and other employee benefits.

Finally, this section permanently limits the number of employees who serve as the personal staff of the Commissioners to four each with the exception that those employees who serve as the personal staff of the Chairman of the Commission are limited to six. This provision was originally contained in the authorization of applications reported by the Committee on Ways and Means and passed by the House. It is included in the committee amendment for purposes of conference.

Section 2405

The committee amendment amends the Tariff Act of 1930 with respect to the selection of the Chairman and the administration of the Commission. This section, which provides for the election of the Chairman of the Commission and modification of the administrative authority of the chairmanship, was contained in the bill as reported by the Committee on Ways and Means and passed by the House. It is included in the committee amendment for purposes of conference.

Section 2406

The committee amendment directs the Commission to continue through 1980 its present practice of publishing statistics with respect to production and the trade in synthetic organic chemicals. This provision was contained in the bill as reported by the Committee on Ways and Means and passed by the House. It is included in the committee amendment for purposes of conference.

D. TITLE XXV—MISCELLANEOUS AMENDMENTS

1. Sick Pay and Military, etc., Pension Exclusion—Injuries Resulting From Acts of Terrorism (sec. 2501 of the bill and secs. 104 and 105 of the Code)

The committee bill excluded from gross income military disability payments attributable to combat-related injuries.

The committee believes that many civilian government employees expose themselves to considerable danger in their work abroad for the government. For example, U.S. Foreign Service officers have been injured and held hostage during political crises at their foreign posts. Representatives at international conferences have been the victims of guerrilla-type terrorist attacks. The committee believes that all government employees who expose themselves to such risks and thereby suffer injuries in the course of their employment should receive tax benefits similar to those which the committee provided to members of the Armed Forces who receive disability payments for combat-related injuries.

This amendment permits employees of the United States Government or any of its branches or agencies, who suffer injuries as a direct result of a violent attack, which the Secretary of State determines to be a terrorist attack, while outside the United States in the course of their employment, to exclude from their gross income any amounts received as disability benefits attributable to such injuries.

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

2. Changes in Treatment of Foreign Income

a. Ordering of foreign tax credit carryover (sec. 2502 of the bill and sec. 904 of the Code)

Under present law, taxpayers generally are required to use any foreign tax credits and investment tax credits arising in the current year to reduce their tax liability before they are allowed to use any credits carried over or back to that year. However, in the case of investment tax credits arising in years before 1971 (i.e., before the investment tax credit was reenacted in 1971), which were carried over to 1971 and later years, these pre-1971 carryovers are to be used before any credits arising in the current year.

In its consideration of the Tax Reform bill the committee agreed to allow foreign and investment tax credit carryovers which otherwise would expire in 1976 to be extended for two additional years in order for the Congress to have time to study further various proposals relating to the treatment of these carryovers. In the case of investment tax credits this means that pre-1971 credits still being carried forward could be used in 1977 or 1978 before any credits arising in the current taxable year.

The committee agreed to a further amendment in order to equate the treatment of foreign tax credit carryovers otherwise expiring in 1976 with the treatment that investment tax credit carryovers from pre-1971 years receive. Thus, under the amendment, any foreign tax credit carryovers which otherwise would expire in 1976 but which have been extended through 1978 are to be used first in 1977 and 1978 against any foreign income received in those years. This should encourage the repatriation of foreign earnings. If this change is not made, companies with foreign tax credit carryovers will be reluctant to bring high-taxed earnings home if foreign tax credits which otherwise would be available for a carryforward are used first before credits that would otherwise expire.

The amendment is to be effective for taxable years ending after December 31, 1975, and before January 1, 1978.

It is estimated that this provision will result in a decrease in budget receipts by $2 million in fiscal year 1977, $3 million in fiscal year 1978, and $1 million in fiscal year 1981.

b. Exclusion for income earned abroad (sec. 2503(a) of the bill and sec. 911 of the Code)

The committee amendment, while retaining the exclusion of up to $20,000 (or in some cases $25,000) for income earned abroad by U.S. citizens living or residing abroad, significantly tightens that provision in three respects. First, the committee amendment provides that no foreign tax credit is allowable with respect to foreign taxes paid on the excluded income. Second, the committee amendment provides that amounts included in income are to be subject to the tax rate brackets which would be applicable if no exclusion had been allowed. Third, the exclusion is not allowed in certain tax avoidance situations.

The impact of the committee amendment may in a few cases result in individuals being better off (if they have paid substantial amounts of foreign income taxes) if there was no exclusion available to them. Accordingly, this amendment provides an election to an individual not to have the earned income exclusion apply. To prevent shifting from an exclusion to a credit system from year to year, the amendment provides that once an election is made not to have the exclusion apply, it is binding for all subsequent years and may be revoked only with the consent of the Internal Revenue Service.

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

c. Recapture of foreign losses (sec. 2503(b) of the bill and sec. 904(f) of the Code)

The committee amendment provides that an overall foreign loss sustained in a taxable year beginning after December 31, 1975, is subject to recapture if in a later year foreign source income is derived. The effective date of the committee amendment is December 31, 1975, but an exception is provided where an investment is substantially worthless prior to the effective date but where the loss is not sustained for tax purposes until 1976. In that case the loss is not subject to recapture if the taxpayer terminates its investment in the loss corporation or corporations by either selling out, or otherwise disposing of, its investment or by liquidating its investment by the end of 1976.

In some cases, a corporation may want to continue an investment beyond 1976 in an attempt to try to make the investment profitable, although it may ultimately fail in that endeavor. This amendment provides that if a loss would qualify for the exception to recapture but for the fact that the investment is not terminated in 1976, if the investment is terminated before January 1, 1979, there is to be no recapture of the loss to the extent there was on December 31, 1975, a deficit in earnings and profits.

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

d. Tax treatment of corporations conducting trade or business in Puerto Rico or possessions of the United States (sec. 2519 of the bill and secs. 33, 931, and 936 of the Code)

The committee amendment permits corporations which qualify for possessions corporation treatment to repatriate their earnings on a current basis and have the dividend eligible for the dividends-received deduction. However, the committee amendment further provides that investment income earned outside of the possession where the profits generating the funds for the investment were derived is to be subject to U.S. tax on a current basis. These provisions apply to taxable years beginning after December 31, 1975.

Possessions corporations wishing to take advantage of the dividends-received deduction provision need to wait until the enactment of this legislation so that they can be assured of the tax treatment which a dividend will receive. In the meantime, these amounts which will be repatriated are invested in income-producing investments. These investments should not be penalized by reason of the delay in enactment of the legislation. Accordingly, this amendment provides that this income is not to be subject to tax even if derived from outside of Puerto Rico or a possession of the United States where the funds were derived if the taxpayer can satisfy the Internal Revenue Service that the income was earned before October 1, 1976.

It is estimated that this provision will result in a decrease in budget receipts of $6 million in fiscal year 1977 from the House provision. For fiscal years subsequent to 1977, it is estimated that this provision will not have any effect on budget receipts.

3. Treatment of Certain Individuals Employed in Fishing as Self-Employed (sec. 2504 of the bill, new sec. 3121(b)(20) and secs. 1402(c) and 3401(a) of the Code, and new sec. 210(a)(20) of the Social Security Act)

A provision in the committee bill treats certain boat crewmen as self-employed individuals for purposes of income tax withholding from wages, the self-employment tax, the Federal Insurance Contributions Act taxes, and the social security laws, when they are engaged in taking aquatic animal life under specified working arrangements. To qualify under the new classification of self-employed individuals, the crewmen, under the committee bill, have to (1) receive only a share of the catch as remuneration, and (2) perform their duties on a boat with an operating crew of less than six.[1]

It appears that many of the fishing operations this provision was designed to help would not be benefitted under the provision as first agreed to by the committee. The committee is informed that many fishing operations, such as a number of those operating in the Gulf Stream, are pursued on an informal employment basis, with frequent turnover of employees working as crewmen. These fishing operations may satisfy the basic criterion of the committee provision, which is that the crewman, to be treated as self-employed, must receive only a share of the catch as remuneration. However, because the boats used in these operations normally use an operating crew of more than five individuals, the crewmen serving on these boats would not be treated as self-employed under the original committee provision.

In addition, the committee provision treats a crewman as meeting the qualifications for treatment as self-employed only if his remuneration is a share of the catch of the boat upon which he serves. In practice, many fishing operations (or other operations in which aquatic animal life, such as shrimp or lobsters, are taken) permit crewmen of one boat to share the catch of several boats. This procedure, of course, is primarily designed to spread whatever catch is made by a group of boats to each crewman, regardless of the relative success of the crewman's particular vessel.

The committee believes this provision should be extended in application to crewmen who receive a share of the catch of the entire group of boats, in the case of an operation involving more than one boat.

This amendment modifies the provision in the committee bill to provide that all crewmen on fishing boats (or boats engaged in taking other forms of aquatic animal life) are to be treated as self-employed individuals if the operating crew of the boat upon which they serve normally consists of fewer than ten individuals, and also if the sole remuneration of these crewmen consists of a share of the catch of the boat, or, in the case of an operation involving more than one boat, consists of a share of the catch of the entire group of boats.

It is estimated that this provision will decrease budget receipts by $65 million over the next five fiscal years.

4. Energy Related Provisions

a. Special credit for wind-related residential energy equipment (sec. 2505(a) of the bill and sec. 44B of the Code)

Present law

Under present law, no special tax credit or deduction is allowed for wind-related energy equipment (such as a traditional windmill) installed with respect to a residence.

[1] The committee report (S. Rept. No. 94–938, p. 385) inadvertently indicated that another qualification required that if a crewman was to be taxed as a self-employed individual, his service on the boat must be on a "substantially intermittent basis." The committee, however, had decided to omit this requirement from its bill.

Reasons for change

The committee believes a tax credit is needed for wind-related energy equipment for much the same reasons tax credits are needed (and provided in the committee's reported bill) for solar and geothermal energy equipment. It is not possible at this time to foresee which of these new industries will be most successful at replacing fossil fuels in providing residential energy sources. The committee believes it appropriate, therefore, to grant wind-related energy equipment the same tax treatment as is provided for solar and geothermal equipment.

Explanation of provision

The committee amendment provides a refundable income tax credit for wind-related energy equipment installed on or adjacent to a residence. Like the solar and geothermal equipment credits, the credit for wind-related energy equipment is 40 percent of the first $1,000 of qualified expenditures, plus 25 percent of the next $6,400 (a maximum credit of $2,000). To qualify, both the equipment and its installation must be paid for by the individual (or individuals) using the edifice as a residence. Thus, the owner or a tenant may qualify, but a builder or developer adding the wind-related equipment to a house he does not intend to use as his residence would not qualify for this credit (although he might qualify for the investment credit given under this amendment for wind-related 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, heat pump, and geothermal equipment and installation must be aggregated with expenditures for wind-related equipment and installation. For example, a taxpayer who has already made purchases of $7,400 for solar equipment allowed during the credit period could not make use of the tax credit for expenditures on wind-related equipment for the same residence.

This tax credit is to be allowed 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 should be continued after 1980. Also, both the installation and the expenditure must occur after June 30, 1976. The credit is for both the expenditures for wind-related equipment itself and also for expenditures for its installation.

Unlike the case of the credit for installation of insulation on an existing residence, wind-related energy equipment expenditures for installations on both existing and newly-constructed residences[1] qualify for the credit.

The credit may be allowed 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 installations of energy equipment for which a special credit provided by this bill was allowed, the dollar limitations on the solar, geothermal, heat pump or wind-related

[1] Condominium and cooperative units may be treated as separate residences.

energy expenditures for which the credit is given must be reduced by the amount of the earlier qualified payments.[2]

If an individual who has already been allowed the maximum credit under the dollar limitations for solar, geothermal, heat pump, or wind-related 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 (or half those amounts, in the case of qualified heat pump expenditures) for equipment installed on his new residence.

The wind-related energy equipment for which the credit may be claimed is that which uses wind-related energy to generate electricity to heat or cool a residence (or residences) or to provide hot water for use inside it, and (1) which meets such standards or criteria for performance as the Secretary of Housing and Urban Development may prescribe, (2) the original use of which commences with the taxpayer, and (3) which has a useful life of at least three years.

At least some of the wind-related equipment for which this credit is provided is expected to be used as an additional source of energy for a residence which also contains a conventional energy source, such as an oil or gas furnace. In this case, the credit, of course, only is available for the additional equipment necessary to permit the wind-related energy to function.

If joint owners install qualified wind-related energy equipment on a common residence, the credit is to be apportioned among those who paid for the equipment and its installation in accordance with the ratio which each owner's payment bears to the total payment during the calendar year. Similarly, if one piece of wind-related equipment provides energy for more than one residence, the residents who benefit from the wind-related energy source are to share the credit according to the ratios of the payment which they bore.

In the case of qualifying expenditures by a cooperative housing corporation, each of the corporation's shareholders 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 the 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 wind-related energy may be shared among 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 wind-related energy expenditure be reduced by the amount of the expenditure that is allowed as a credit. For example, assume that the taxpayer makes

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[2] 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.

$2,500 of qualified expenditures of the sort which would normally increase his basis in his home. The maximum credit allowable in this case is $775 (40 percent of the first $1,000, plus 25 percent of the remaining $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 tax credit).

The wind-related energy equipment 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.

The House bill contains no comparable provision.

Effective date

The committee amendment makes 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 after 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 this provision will result in a decrease in budget receipts of less than $5 million annually.

b. Special investment credit for wind-related energy equipment used in the production of electricity (sec. 2505(b) 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 types of business machinery, equipment, and facilities used in a trade or business or held for the production of income. As a facility used as an integral part of the production of electrical energy, wind-related energy equipment used to generate electricity may be entitled to the investment credit of present law (sec. 48(a)(1)(B)(i)), unless it is a structural component of a building.

Reasons for change

The committee believes it is important to encourage the development of new methods of generating electricity that do not involve the consumption of fossil fuels. Through the use of a special investment credit for this purpose, the committee hopes to help preserve an adequate supply of electrical energy for our industrial and business needs, while simultaneously conserving fossil fuel and mitigating fossil fuel energy shortages. Since the use of windmills in the generation of electricity is in a new stage of development, in which new and more efficient ways of producing electricity through the use of windmills are being discovered, the committee believes a tax credit is needed to encourage this new development to continue at a more rapid pace than could otherwise be expected.

Explanation of provision

The committee amendment extends the investment credit (at an increased rate for a limited period of time) to wind-related energy equipment (such as windmills) installed for use in the trade or business of producing electricity or to generate electricity for use in a trade or business. The amount of the credit is to be 20 percent of the qualified wind-related energy equipment installation investment after May 25, 1976, and before January 1, 1982. After that time, the credit is reduced to 10 percent for this type of investment through 1986.[1] Both the 20-percent and the 10-percent credits apply to the costs of the wind-related energy equipment itself, as well as the costs of its installation.

The credit is to be applicable whether or not the wind-related energy equipment would otherwise fail to qualify for the general investment credit because it is a structural component of a building.

In the case of wind-related energy property under construction on May 25, 1976, this special investment credit is to apply only to that portion of the basis of the property which is attributable (in accordance with Treasury regulations) to construction, reconstruction, or erection after that date.

This credit is not to apply to any equipment acquired by the taxpayer with amounts paid him as a grant by the Federal Government, or by any of its agencies or instrumentalities, unless the grant was made in the form of a loan or a loan guarantee.

In addition to the 20- and 10-percent special investment credits, an additional 2-percent investment credit is to be available for taxpayers who establish or maintain an appropriate employee stock ownership plan to which the employer contributes stock equal to 2 percent of the qualified investment in the wind-related energy property.[2]

The House bill contains no comparable provision.

Effective date

To qualify for the 20-percent credit, the wind-related energy equipment must be acquired, constructed, reconstructed, or erected by the taxpayer after May 25, 1976, and placed in service before January 1, 1982. Similarly, to qualify for the 10-percent credit allowance applicable after 1981, the equipment must be placed in service after December 31, 1981, and before January 1, 1987. In the case of both pre-1982 and pre-1987 wind-related energy 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.

Revenue effect

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

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[1] The applicable investment credit for wind-related energy property after 1981, and before 1987, is to be 10 percent regardless of whether the general investment credit rate at that time is 10 percent.

[2] See section 301(d) of the Tax Reduction Act of 1975 (P.L. 94–12, 89 Stat. 26).

5. Sliding-Scale Inclusion Ratio for Capital Gains (sec. 2506 of the bill and sec. 1202 of the Code)

Present law

Individuals (and estates and trusts) may deduct from gross income one-half of the excess of their long-term capital gains over their short-term capital losses.

Reasons for change

The committee believes that the tax on capital gains should be reduced for assets that have been held for long periods of time. This reduction is desirable because of the need to encourage additional savings by individuals, particularly in equity securities, and to improve the mobility of capital in the economy.

In 1975, Americans saved only 8.3 percent of their disposable personal income. This rate is lower than that achieved by virtually every other major industrialized country. Meanwhile, the nation has vast unmet investment needs. The nation needs capital for expansion in industries where there have been shortages, such as the steel, paper, and chemical industries; for additional housing; for pollution control; and for greater self-sufficiency in energy. Unless the Federal Government can run budget surpluses, which is unlikely in view of the fact that there have been budget deficits in ten of the past eleven years, these investment needs can be met only by increased private savings. This, in turn, requires more favorable tax treatment of the income from capital.

The committee believes that lower capital gains taxes will have several beneficial effects on the economy. It will encourage individuals to save by purchasing assets on which they expect to receive capital gains, including common stocks. Additional equity investment is needed in the United States to finance new businesses, which traditionally rely on equity financing, and to enable existing corporations to reduce their debt-to-equity ratios, which have become dangerously high in recent years.

The lower capital gains rates will also improve the mobility of capital in the economy. Because capital gains on an asset are subject to taxation when the asset is sold, individuals are discouraged from selling assets in order to postpone their capital gains tax. This so-called "lock-in effect" means that some corporations, on whose securities there are substantial accrued capital gains, can raise capital more cheaply than other corporations, which causes inefficient allocation of capital between companies. The sliding scale should reduce this lock-in effect.

Explanation of provision

The bill provides a capital gains deduction (in addition to the existing 50-percent deduction) equal to one percent of an individual's capital gain on an asset multiplied by the number of years in excess of five years that the asset was held. The additional deduction on each asset is to be limited to 20 percent of the capital gain on that asset (for holding periods exceeding 25 years). Also, a taxpayer's total for both deductions is to be no more than 75 percent of his net capital gain (the excess of his net long-term capital gains over net short-term capital losses).

The additional capital gains deduction is to be available only for certain assets. These include securities, real property, partnership interests, and business goodwill of proprietorships. In the case of goodwill, the amount of the sales price that the seller may allocate to goodwill cannot exceed the amount that the purchaser allocates to goodwill. This limitation is designed to prevent taxpayers from allocating a disproportionate share of their capital gain to goodwill. Qualifying assets include those held by pass-through entities where gains realized by the entity are includible in gross income of the taxpayer.

The amendment repeals the alternative tax rate of 25 percent on the initial $50,000 of net long-term capital gains of individuals.

The rules for determining holding periods will generally be those currently used to distinguish short-term and long-term capital gains. In the case of real property, however, the rules will generally be those used to determine the phaseout of the depreciation recapture provision in section 1250, except for certain involuntary conversions and like-kind exchanges where the property-owner will be able to tack the holding period of the old property onto that of the new property. There are also rules defining substantial additions to basis. These will require the taxpayer to consider the addition as a separate asset with its own holding period.

The House bill does not contain a comparable provision.

Effective date

The additional exclusion will apply to all gains on assets sold during taxable years beginning after December 31, 1977.

Revenue effect

It is estimated that this provision will decrease budget receipts by $719 million in fiscal year 1979, $791 million in fiscal year 1980, and $870 million in fiscal year 1981.

6. Pensions, ESOP's and Related Items

a. Taxable status of Pension Benefit Guaranty Corporation (sec. 2507 of the bill and sec. 4002(g) of the Employee Retirement Income Security Act of 1974)

Present law

Under present law (sec. 501(c)(1)), a corporation organized under an Act of Congress is, in general, not exempt from Federal income taxation unless that Act (either in its original or in an amended and supplemented form) specifies that the corporation is to be exempt.

The Pension Benefit Guaranty Corporation (PBGC) was established by title IV of the Employee Retirement Income Security Act of 1974 (ERISA), primarily to administer a pension plan termination insurance program. The PBGC guarantees certain vested retirement benefits (within limitations) that would otherwise be lost to workers because of failure of their retirement plans. ERISA exempts the PBGC from State or local taxation (ERISA, sec. 4002(g)(1)), with a few specific exceptions, but does not, in terms, provide for exemption of the PBGC from Federal income taxation.

The PBGC does not fall within any of the other categories of organizations entitled to Federal income tax exemption. It lacks a charitable or other purpose (required under sec. 501(c)(3)), and, while it promotes social welfare, it lacks the membership characteristic (required by sec. 501(c)(4)).

As a result, it appears probable that the PBGC would be treated as subject to Federal income taxation.[1]

Reasons for change

The Congress intended the PBGC to be exempt from Federal taxation, but this exemption was apparently deleted from the final bill through an oversight.

Explanation of provision

The committee amendment modifies section 4002(g)(1) of ERISA to exempt the Pension Benefit Guaranty Corporation from any Federal taxation, except with respect to taxes under the Federal Insurance Contributions Act (social security) and the Federal Unemployment Tax Act.[2] The exemption is to extend to the PBGC both in its corporate capacity and in its capacity as a trustee for terminated retirement plans. The exemption extends to the corporation's property, franchise, capital reserves, surplus, and to its income. The exempt income is to include, of course, the income earned by corporate investments out of premium payments and to income earned by plans for which the PBGC is acting as a fiduciary.

The House bill does not contain a comparable provision.

Effective date

The amendment to ERISA is effective from September 2, 1974 (the date of ERISA's enactment). Thus, the exemption of the PBGC from Federal taxation is to operate retroactively, as well as prospectively.

Revenue effect

This amendment clarifies the original intent of the Congress and does not have any revenue effect.

b. Level premium annuity contracts held by H.R. 10 plans (sec. 2508 of the bill and sec. 415(c) of the Code)

Present law

Under present law, if an owner-employee[1] is covered by a tax-qualified plan (an "H.R. 10 plan"), the employer is not permitted to contribute to the plan more than $7,500 or 15 percent (whichever is less) of the owner-employee's earned income (secs. 401(d)(5) and 404

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[1] As a practical matter, the PBGC's Federal income tax liabilities would be primarily on account of premiums paid for plan termination insurance coverage and investment income earned on these premiums, as well as on account of the investment income earned through the operation of terminated plans in the PBGC's fiduciary capacity.

[2] Imposed under chapters 21 and 23, respectively, of the Code.

[1] An owner-employee is an employee who owns the entire interest in an unincorporated trade or business or, in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in that partnership (sec. 401(c)(3)).

(e)). If the plan is funded with level premium annuity contracts, under which a fixed premium of $7,500 or less is paid without regard to the owner-employee's earnings, present law dealing specifically with H.R. 10 plans (1) permits contributions to be made to the plan in an amount sufficient to pay the premiums on the contract (subject to the requirement that the premium not exceed the owner employee's average deductible amounts for a 3-year period), but (2) does not allow a deduction for amounts contributed for the owner-employee in excess of 15 percent of his earned income (secs. 401(d)(5), 401(e), and 404(e)). However, under a separate provision which provides overall limitations on contributions to all qualified plans (sec. 415), the contributions on behalf of an owner-employee cannot exceed 25 percent of his earned income. (That provision is modified, in the case of certain lower-income owner-employees, by another provision in this bill—sec. 1503 of the bill as reported by the committee, the so-called "jockeys amendment".)

Reasons for change

The 25-percent overall limitation frustrates the H.R. 10 plan provisions regarding level premium annuity contracts which would otherwise permit nondeductible plan contributions to be made even though they exceed 15 percent of the owner-employee's earned income. If the 25-percent rule is not modified, the committee is concerned that many H.R. 10 plans would not be able to be continued in their present form.

Explanation of provision

The amendment permits contributions to be made to an H.R. 10 plan on behalf of an owner-employee under annuity contracts despite the overall 25-percent limitation if no other amounts are added to his account for the year under any other defined contribution plan or tax-sheltered annuity maintained by the employer or a related employer and if the employee is not an active participant for the year in a defined benefit plan maintained by the employer or a related employer. Under the amendment, the overall limitations which apply where an employee participates in both a defined contribution plan and a defined benefit plan are not changed. No comparable provision is included in the House bill.

Effective date

The amendment applies for years beginning after December 31, 1975, the effective date of the overall limitations.

Revenue effect

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

c. Employee stock ownership plans (sec. 2517 of the bill, sec. 301(d) of The Tax Reduction Act of 1975, and secs. 401 and 4975 of the Code)

The committee amendment makes several changes in present law relating to employee stock ownership plans (sec. 804 of the bill, as reported by the committee). After further consideration, the committee decided that certain of these amendments should be more closely coordinated with the Committee on Labor and Public Welfare before any action is taken. Accordingly, the committee decided to delete them from its amendment. These provisions would have—

(1) required employee stock ownership plans funded with investment tax credit to provide broader coverage of employees (sec. 804(c)(5) of the bill, as reported), and

(2) ended the treatment of an employee stock ownership plan as a pension or welfare plan under Federal law other than tax law (sec. 804(g) of the bill, as reported).

d. Election not to participate in an employee stock ownership plan (sec. 2517 of the bill, sec. 301(d) of the Tax Reduction Act of 1975, and sec. 4975 of the Code)

Present law

Present law is silent as to whether an employee is to have a choice to participate or not in a pension, profit-sharing, or other qualified plan. Any such right to be included or excluded depends on the provisions of the plan. However, the plan may lose its qualified status if it fails to satisfy breadth-of-coverage requirements in the law (sec. 410).

Reasons for change

The committee believes that increased ownership in corporations by employees is desirable from several standpoints. It provides a way of increasing an employee's interest in the productivity and success of the company he is working for, it provides a form of savings for the employee, and at the same time it provides a new source for capital for the company. The committee believes that all of these purposes are worthwhile and should be encouraged. The committee view in this regard is indicated by the fact that in the committee amendment previously offered a provision was made for an additional 2 percentage points of investment credit in cases where the tax savings resulting were made available for employee stock ownership plans.

At the same time, however, the committee does not believe that employees should be forced to participate in employee stock ownership plans against their own desire. In fact, by making such plans voluntary with the employee, it is anticipated that employee interest in them will be raised and that the terms under which such plans may be offered will be more attractive from the employee standpoint. For these reasons this amendment permits an employee to elect out of an employee stock ownership plan.

Explanation of provision

The amendment provides that an employee stock ownership plan must permit an employee to opt out of the plan before the 31st day after he first becomes eligible to participate in the plan. Also, if a conventional plan is amended to become an employee stock ownership plan, under the plan as amended the employee must be given the right to opt out of the plan before the 31st day after the later of the date of the plan amendment or its effective date.

Under the committee amendment the plan is not required to allow an employee to opt out of the plan if he is included in a unit of employees described in section 410(b)(2)(A) (relating to exclusion of certain employees). The provision added by the amendment is satisfied if all employees who are included in such a unit are bound by the decision of the unit regarding participation.

The amendment does not have any effect on the requirement that an employee stock ownership plan satisfy the breadth-of-coverage provisions in the law (sec. 410) in order to be qualified.

Effective date

The amendment applies after December 31, 1976.

Revenue effect

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

7. Tax-Exempt Organizations and Charitable Contributions

a. Unrelated business income from services provided by a tax-exempt hospital to other tax-exempt hospitals (sec. 2509 of the bill and sec. 513 of the Code)

Present law

Present law (secs. 511 through 514) imposes a tax on the unrelated business income of most exempt organizations, including hospitals which are exempt under section 501(c)(3) (relating to organizations organized and operated for religious, charitable, scientific, educational, etc. purposes). The term "unrelated trade or business" is defined (sec. 513) as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of any religious, charitable, scientific, educational, etc., purpose. In Rev. Rul. 69–633, 1969–2 CB 121, the Internal Revenue Service ruled that income which a tax-exempt hospital derives from providing laundry services to other tax-exempt hospitals constitutes unrelated business taxable income to the hospital providing the services, since the providing of services to other hospitals is not substantially related to the exempt purposes of the hospital providing the services.

Reasons for change

Under present law, a tax-exempt hospital which directly provides certain services needed in its function as an exempt hospital is not taxed on the imputed income from those services. In addition, under present law (as expanded by other amendments made by the committee), several tax-exempt hospitals can create and operate, on a cooperative basis, a new tax-exempt organization to provide those services to its members.

However, it is often impractical for a number of small hospitals to perform these services directly or to create a separate cooperatively-operated organization to provide these services. Instead, it may be more practical for one hospital to provide these services to several small tax-exempt hospitals for a fee. The committee believes that such arrangements should be encouraged since they often result in a cost savings to the hospital and its patients. Moreover, the committee does not believe that a hospital providing such services substantially competes with other organizations which are not tax-exempt.

Explanation of provision

The committee amendment provides that a hospital is not engaged in an unrelated trade or business simply because it provides services to other hospitals if those services could have been provided, on a tax-free basis, by a cooperative organization consisting of several tax-exempt hospitals. The exclusion from the unrelated business tax applies only where the services are provided only to other tax-exempt hospitals, each one of which has facilities to serve not more than 100 inpatients, and (2) the services would be consistent with the recipient hospital's exempt purpose.

Effective date

This amendment applies to all "open" taxable years to which the Internal Revenue Code of 1954 applies.

Revenue effect

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

b. Hospital laundry facilities (sec. 2509 of the bill and sec. 501(e) of the Code)

Present law

Under present law (sec. 501(e)), certain cooperatively-operated service organizations which have been created by tax-exempt hospitals are also considered to be tax-exempt charitable organizations. In order to qualify for that tax-exempt status, a hospital service organization (1) must be organized and operated solely to perform certain specified services which, if performed directly by a tax-exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and (2) must perform these services solely for two or more tax-exempt hospitals. That provision does not apply to organizations which perform services other than those listed in the statute, such as laundry services. (See H. Rept. 1533, 90th Cong., 2d Sess.) In Rev. Rul. 69–633, 1969–2 CB 121, the Internal Revenue Service ruled that a cooperatively-operated organization performing laundry facilities for various tax-exempt hospitals is not exempt under that provision, but may qualify for tax treatment as a cooperative under sections 1381 to 1383 of the Code.

Reasons for change

Under present law, it is possible for a cooperatively-operated laundry facility to avoid paying any Federal income tax if it returns any excess income to its exempt hospital members as patronage dividends.

The committee believes that it is appropriate to encourage the creation and operation of cooperative service organizations by exempt hospitals because of the cost savings to the hospitals and their patients that result from providing certain services, such as laundry and clinical services, on a cooperative basis. Moreover, exemption from State taxation which this would facilitate in many cases would be particularly helpful in the case of laundry and clinical services, since they require relatively substantial investments in plant and equipment.

Explanation of provision

The committee amendment adds the performance of laundry and clinical services to the types of services that can be performed on a cooperative basis by tax-exempt hospitals. Thus, it is permissible, under the committee amendment, for tax-exempt hospitals to create a cooperative service organization to provide a laundry and clinical facilities to these hospitals.

Effective date

The amendment is effective for taxable years ending after December 31, 1976.

Revenue effect

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

c. *Donation of Government publications (sec. 2510 of the bill and sec. 1221 of the Code)*

Present law

In most situations, Government publications received by taxpayers without charge (e.g., copies of the Congressional Record received by Members of Congress) or at a reduced price are treated as capital assets under current law. One consequence of that treatment is that taxpayers can claim a deduction for the full fair market value of any Government publication which they contribute to a charity (such as a library or a university) for a use related to the charity's exempt purpose. Even where the publications are given to a charity which would not use them in a manner related to its exempt purpose, an individual taxpayer can claim a charitable contribution deduction for the amount, if any, paid for the Government publication and, in addition, one-half of the difference between that amount and their fair market value.

Reasons for change

The committee believes that an unwarranted double benefit can be obtained under current law where taxpayers can both receive publications from the Government free (or for less than the price at which those publications are sold to the public), and can also reduce their income taxes by giving away those Government publications to charity and claiming a deduction for the fair market value of the publications.

Explanation of provision

Under the committee amendment, U.S. Government publications which are received by any taxpayer from the Government without charge or below the price at which they are sold to the general public are no longer to be treated as capital assets in the hands of the taxpayer receiving the publications. This treatment is also to apply to any Government publication held by a taxpayer in whose hands the basis of that publication is determined by reference to its basis in the hands of a person receiving it free or at a reduced price (for example, if a Member of Congress gives to another person the Congressional

Records that the Member had received free, then that other person would be treated the same as the Member under this provision).

One result of treating Government publications under these circumstances as non-capital assets is that if such a taxpayer contributes the publications to charity, then he will in effect be able to deduct only the amount, if any, he paid for the publications. Another result is that if such a taxpayer sells the publications, the gain on the sale will be subject to tax at ordinary income rates rather than capital gains rates.

Effective date

This amendment applies to Government publications contributed or sold after the date of the bill's enactment.

Revenue effect

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

d. Certain charitable contributions of inventory (sec. 2511 of the bill and sec. 170 of the Code)

Present law

Under present law (sec. 170(e)), a taxpayer who makes a charitable contribution of property must reduce the amount of the deduction (from fair market value) by the amount of ordinary gain he would have realized had the property been sold instead of donated to charity. (Under certain circumstances, a taxpayer may have to reduce the amount of his charitable contribution by a portion of the capital gain he would have received if the property had been sold.) Thus, the donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) may deduct only his basis in the property rather than its full fair market value.

When this rule was added to the Code in 1969, it was intended, in part, to prevent the abuse situations in which taxpayers in high marginal tax brackets and corporations could donate to charity substantially appreciated ordinary income property and actually be better off, after tax, than they would have been if they had sold the properties and retained all the after-tax proceeds of the sales.

Reasons for change

The rules that provide that the donor of appreciated ordinary income property can deduct only his basis in the property have effectively eliminated the abuses which led to their enactment; however, at the same time, they have resulted in reduced contributions of certain types of property to charitable institutions. In particular, those charitable organizations that provide food, clothing, medical equipment, and supplies, etc., to the needy and disaster victims have found that contributions of such items to those organizations have been reduced.

The committee believes that it is desirable to provide a greater tax incentive than in present law for contributions of certain types of ordinary income property which the donee charity uses in the performance of its exempt purposes. However, the committee believes that the deduction allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Explanation of provision

The committee amendment allows a corporation (other than a subchapter S corporation) a deduction for up to half of the appreciation on certain types of ordinary income property contributed to a public charity or a private operating foundation.

In order to qualify for this treatment, the following conditions must be satisfied: (1) the donee must use the property in a use related to its exempt purpose and solely for the care of the ill, the needy, or infants; (2) the donee must not transfer the property in exchange for money, other property, or services; and (3) the donor must receive a statement from the donee representing that its use and disposition of the property will comply with requirements (1) and (2) above.

If all these conditions are complied with, the charitable deduction will generally be for the sum of (1) the taxpayer's basis in the property and (2) one-half of the unrealized appreciation. However, in no event is a deduction to be allowed for an amount which exceeds twice the basis of the property. Furthermore, no deduction is to be allowed for any part of the unrealized appreciation which would have been ordinary income (if the property had been sold) because of the application of the recapture provisions relating to depreciation, certain mining exploration expenditures, certain excess farm losses, certain soil and water conservation expenditures, and certain land-clearing expenditures.

Effective date

This provision applies to charitable contributions made after the date of the bill's enactment.

Revenue estimate

It is estimated that this provision will result in a decrease in budget receipts of $16 million in fiscal year 1977, $22 million in fiscal year 1978, and $24 million in fiscal year 1981.

e. Lobbying activities of public charities (sec. 2512 of the bill and secs. 501(h) and 4911 of the Code)

Present law

Present law (sec. 501(c)(3)) imposes upon every organization qualifying for tax-exempt status as an educational, charitable, religious, etc., organization the requirement that "no substantial part of the activities of [the organization] is carrying on propaganda, or otherwise attempting, to influence legislation". This requirement is also a precondition of such an organization's qualification to receive charitable contributions that are deductible for income, estate, or gift tax purposes (secs. 170(c), 2055(a), 2106(a), 2522(a), and 2522(b)).

Reasons for change

The language of the lobbying provision was first enacted in 1934. Since that time neither Treasury regulations nor court decisions have given enough detailed meaning to the statutory language to permit most charitable organizations to know approximately where the limits are between what is permitted by the statute and what is forbidden by it. This vagueness is, in large part, a function of the uncertainty in the meaning of the terms "substantial part" and "activities".

Many believe that the standards as to the permissible level of activities under present law are too vague and thereby tend to encourage subjective and selective enforcement.

Except in the case of private foundations, the only sanctions available at present with respect to an organization which exceeds the limits on permitted lobbying are loss of exempt status under section 501(c)(3) and loss of qualification to receive deductible charitable contributions. Some organizations (particularly organizations which have already built up substantial endowments) can split up their activities between a lobbying organization and a charitable organization. For such organizations, these sanctions may have little effect, and this lack of effect may tend to discourage enforcement effort.[1]

For other organizations which cannot split up their activities between a lobbying organization and a charitable organization and which must continue to rely upon the receipt of deductible contributions to carry on their exempt purposes, loss of section 501(c)(3) status cannot be so easily compensated for and would constitute a severe blow to the organization.

The committee amendment is designed to set relatively specific expenditure limits to replace the uncertain standards of present law, to provide a more rational relationship between the sanctions and the violations of standards, and to make it more practical to properly enforce the law. However, these new rules replace present law only as to charitable organizations which elect to come under the standards of the amendment. The new rules also do not apply to churches and organizations affiliated with churches, nor do they apply to private foundations; present law is to continue to apply to these organizations. The amendment provides for a tax of 25 percent of the amount by which the expenditures exceed the permissible level. Revocation of exemption is reserved for those cases where the excess is unreasonably great over a period of time.

Explanation of provision

The committee amendment permits public charitable tax-exempt organizations to elect to replace the present "substantial part of activities" test with a limit defined in terms of expenditures for influencing legislation. The basic permitted level of such expenditures ("lobbying nontaxable amount") for a year is 20 percent of the first $500,000 of the organization's exempt purpose expenditures for the year, plus 15 percent of the second $500,000, plus 10 percent of the third $500,000, plus 5 percent of any additional expenditures. How-

[1] The Treasury Department's regulations (Regs. § 1.501(c)(3)–1(c)(3)(v)) specifically provide that an organization that loses its exempt status under section 501(c)(3) because of excessive lobbying can become exempt on its own income under section 501(c)(4) as a "social welfare" organization. Also, a number of organizations that have in this manner shifted to section 501(c)(4) have created related organizations to carry on their charitable activities, to qualify for exemption under 501(c)(3), and to qualify to receive deductible charitable contributions. If the original organization has built up a substantial endowment during its years of section 501(c)(3) status, it can then carry on its "excessive" lobbying activities financed by the income it receives from its tax-deducting endowment. As a result, although there may have been some inconvenience and administrative confusion during the changeover period, it is possible in such a case for the lobbying rules to be violated without any significant tax consequences.

ever, in no event is this permitted level to exceed a "cap" of $1,000,000 for any one year.

Within those limits, a separate limitation is placed on so-called "grass roots lobbying"—that is, attempts to influence the general public on legislative matters. This grass roots nontaxable amount is one-fourth of the lobbying nontaxable amount.

The committee amendment is substantively the same as H.R. 13500, which was recently passed by the House, except that the House bill disallowed charitable deductions for out-of-pocket expenditures to influence legislation even if the expenditures were for the use of organizations which are ineligible to elect the expenditures test.

Sanctions.—An electing organization that exceeds either the general limitation or the grass roots limitation in a taxable year is to be subject to an excise tax of 25 percent of its excess lobbying expenditures.[2] Furthermore, if an electing organization's lobbying expenditures normally (that is, on the average over a four-year period) exceed 150 percent of the limitations described above, the organization is to lose its exempt status under section 501(c)(3).[3]

Influencing legislation.—For purposes of these new rules, the amendment defines the term "influencing legislation" as any attempt to influence any legislation through an attempt to affect the opinion of the general public or any segment thereof ("grass roots lobbying") and any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation ("direct lobbying").

The committee amendment excludes from "influencing legislation" the following three categories of activities: (1) making available the result of nonpartisan analysis, study, or research; (2) providing technical advice or assistance in response to a written request by a governmental body; and (3) appearances before, or communications to, any legislative body with respect to a possible decision of that body which might affect the existence of the organization, its powers and duties, its tax exempt status, or the deduction of contributions to the organization.

In addition, the committee amendment excludes communications between the organization and its bona fide members unless the communications directly encourage the members to influence legislation or directly encourage the members to urge nonmembers to influence legislation.[4]

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[2] If, for a year, the organization's expenditures exceed both the nontaxable lobbying amount and the nontaxable grass roots amount, then the 25-percent tax is to be imposed on whichever one of these excesses is the greater. This excise tax, like the excise taxes imposed with respect to private foundations and qualified pension, etc., plans, is in no event to be deductible.

[3] An organization's lobbying expenditures "normally" exceed 150 percent of the permitted amount if (1) the sum of its lobbying expenditures (or grass roots expenditures) for the 4 years immediately preceding the current year is greater than (2) 150 percent of the sum of the "lobbying nontaxable amounts" (or grass roots nontaxable amounts) for those same 4 years.

[4] An allocable portion of the cost of a publication which is designed primarily for members and which includes some material directly encouraging the members to engage in direct lobbying is to be treated as an expenditure for direct lobbying. However, the fact that some copies of the publication are distributed to libraries and other bona fide subscribers will not cause any portion of those expenditures to be treated as expenditures for grass roots lobbying. On the other hand, if more than 15 percent of the copies of the publications are distributed to nonmembers (including libraries), the portion of the cost of the publication allocable to the lobbying material is to be allocated between the activities relating to members and the activities relating to nonmembers (grass roots lobbying) in proportion to the distribution of the publication.

Exempt purpose expenditures.—As indicated above, the determination of whether an electing organization is subject to the excise tax established by the amendment is to be made by comparing the amount of the lobbying expenditures with the organization's "exempt purpose expenditures" for the taxable year. The term "exempt purpose expenditures" includes the total of the amounts paid or incurred by the organization for exempt religious charitable, educational, etc., purposes.

In computing exempt purpose expenditures, amounts properly chargeable to capital account are to be capitalized. However, when the capital item is depreciable, then a reasonable allowance for depreciation, computed on a straight-line basis, is to be treated as an exempt purpose expenditure.

For purposes of these provisions, the term "exempt purpose expenditure" also includes administrative expenses paid or incurred with respect to any charitable, etc., purpose; it also includes all amounts paid or incurred for the purpose of influencing legislation, whether or not for exempt purposes.

Exempt purpose expenditures do not include amounts paid or incurred to or for a separate fund-raising unit of an organization (or an affiliated organization's fund-raising unit); they also do not include amounts paid or incurred to or for any other organization, if those amounts are paid or incurred primarily for fundraising.

Affiliation rules.—In order to forestall the creation of numerous organizations to avoid the effects of the decreasing percentages test used to compute the lobbying and grass roots nontaxable amounts, or efforts to avoid the $1,000,000 "cap" on lobbying expenditures, the amendment provides a method of aggregating the expenditures of related organizations.

If two or more organizations are members of an affiliated group, and at least one organization in that group has elected to come under the new rules of the committee amendment, then the calculations of lobbying expenditures and exempt purpose expenditures are to be met by taking into account the expenditures of the entire group. If the expenditures of the group as a whole exceed the permitted limits, each of the electing organizations is to pay the tax on its proportionate share of the group's excess lobbying expenditures. The nonelecting members of the group are to remain under existing law with regard to their expenditures and other activities.

Generally, two organizations are affiliated if (1) one organization is bound by decisions of the other organization on legislative issues, or (2) the governing board of one organization includes enough representatives of the other organization to cause or prevent action on legislative issues by the first organization.[5] Where organizations are affiliated, as described above, in a chain or similar fashion, all organizations in the chain are to be treated as one group of affiliated organizations. Thus, for instance, if organization Y is bound by the deci-

[5] There is affiliation if either of the two conditions is satisfied, that is, if there is either control through the operation of the governing instrument or voting control through "interlocking directorates." In general, any degree of control by operation of governing instruments is enough to satisfy this affiliation test. The existence of the power is sufficient, whether or not the "controlling" organization is exercising the power. However, the committee amendment provides a special rule to apply in certain limited control situations where the affiliation in the group exists solely because of the control provisions of governing instruments (i.e., there are no interlocking directorates) and where those control provisions operate only with respect to national legislation.

sions of organization X on legislative issues and organization Z is bound by the decisions of organization Y on such issues, then X, Y, and Z are all members of one affiliated group of organizations. However, if a group of autonomous organizations control another organization but no one organization in the controlling group can, by itself, control the actions of the potentially controlled organization, the organizations are not treated as an affiliated group by reason of the "interlocking directorates" rule.

Where there is an affiliated group, a number of the provisions discussed above are to be applied as though the affiliated group constitutes one organization.

Disallowance of deduction for out-of-pocket expenses to influence legislation.—Under present law, a deduction is available for certain out-of-pocket expenditures incurred by a person on behalf of a charitable organization. Since, for purposes of the new expenditures test, it is necessary to have relevant expenditures appear in the books and records of the organizations, an expenditures test could readily be evaded if the lobbying could be conducted on behalf of the organization by individuals with deductible out-of-pocket contributions. Accordingly, the amendment provides that a person may not deduct out-of-pocket expenditures on behalf of a charitable organization if the expenditure is made for the purpose of influencing legislation.[6] and if the organization is eligible to elect the expenditures test provided by the committee amendment.

Status of organization after loss of charitable status.—Under present law, an organization which loses its exempt status under section 501(c)(3) generally can nevertheless remain exempt on its own income (although generally ineligible to receive deductible charitable contributions) as a "social welfare" organization under section 501(c)(4)). The availability of this continued exemption permits an organization to build up an endowment out of deductible contributions as a charitable organization and then use that tax-favored fund to support substantial amounts of lobbying as a section 501(c)(4) social welfare organization.[7]

In order to prevent such a transfer of charitable endowment, the committee amendment provides that an organization which is eligible to elect under this provision cannot become a social welfare organization exempt under section 501(c)(4) if it has lost its status as a charity because of excessive lobbying. The committee amendment also gives the Treasury Department the authority to prescribe regulations to prevent avoidance of this rule (for example, by direct or indirect transfers of all or part of the assets of an organization to an organization controlled by the same person or persons who control the transferor organization).

Disclosure of lobbying expenditures.—In order to permit the public to obtain information as to lobbying expenditures by organiza-

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[6] Treasury Regulations § 1.170A-1(h)(6) provide that "No deduction shall be allowed under section 170 for expenditures for lobbying purposes, promotion or defeat of legislation, etc." However, it is not clear that this provision of the Regulations has been applied to disallow deductions for such expenditures.

[7] State law would in the usual case require the funds originally dedicated to charitable purposes to remain so dedicated, even though the organization may have lost its Internal Revenue Code charitable status. However, it is not clear whether State law would prevent such an organization from carrying on substantial lobbying activities.

tions that have elected to come under the standards of the new provisions, the amendment revises section 6033 to specifically require that any organization that has elected under these rules must disclose on its information return the amount of its lobbying expenditures (total and grass roots), together with the amount that it could have spent for these purposes without being subject to the new excise tax provided by the committee amendment. If an electing organization is a member of an affiliated group, then it must provide this information with respect to the entire group, as well as with respect to itself.

This amendment is not intended to restrict any authority that the Treasury Department may have under existing law to require exempt organizations to provide information for the purpose of carrying out the internal revenue laws.

Elections.—An election by an organization to have its legislative activities measured by the new expenditures test is to be effective for all taxable years of the organization which end after the date the election is made, and begin before the date the election is revoked by the organization. Thus, an organization can, at any time before the end of the taxable year, elect the new rules for that taxable year. Once such an election is made, it can be revoked only prospectively—that is, it cannot be revoked for a taxable year after that year has begun.

Eligible organizations.—As a result of concerns expressed by a number of churches and in response to their specific request, the committee amendment does not permit a church or a convention or association of churches (or an integrated auxilary or a member of an affiliated group which includes a church, etc.), to elect to come under these provisions.[8]

Effect of court decision.—The committee is aware of the recent tax litigation involving Christian Echoes National Ministry, Inc.

In the course of their opinions, the various courts which rendered decisions in this litigation stated conclusions regarding a number of legal issues or issues of mixed law and fact.

The committee has proceeded on this provision without evaluating that litigation. So that unwarranted inferences may not be drawn from the adoption of this amendment, the commitee states that its actions are not to be regarded in any way as an approval or disapproval of the decision of the Court of Appeals for the Tenth Circuit in *Christian Echoes National Ministry, Inc.* v. *U.S.*, 470 F. 2d 849 (1972), or of the reasoning in any of the opinions leading to that decision.

Effective dates

In order to provide time for the Treasury Department to promulgate the necessary regulations interpreting the committee amendment and providing for making elections under the new rules, the provisions of the committee amendment, with certain limited exceptions, become effective only for taxable years beginning after December 31, 1976. However, the rule which provides that a section 501(c)(3) or-

[8] Since private foundations are already subject to excise taxes on activities involving influencing legislation under section 4945, they are ineligible for these new rules. Also, organizations which are public charities because they are support organizations (under section 509 (a)(3)) of certain types of social welfare organizations (sec. 501(c)(4)), labor unions, etc. (sec 501(c)(5)), or trade associations (sec. 501(c)(6)) are ineligible to make this election.

ganization which loses its charitable, etc., status because of excess lobbying cannot thereafter be exempt under section 501(c)(4) applies to activities occurring after the date of enactment. The amendments conforming the estate tax charitable deduction provisions apply to the estates of decedents dying after December 31, 1976, and the amendments conforming the gift tax charitable deduction requirements apply to gifts in calendar years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will affect budget receipts by less than $5 million annually.

f. Tax liens, etc., not to constitute "acquisition indebtedness" (sec. 2513 of the bill and sec. 514(c)(2) of the Code)

Present law

Generally, organizations which are exempt from Federal income tax (under section 501(a)) are taxed only on income from trades or businesses which are unrelated to the organization's exempt purposes; they are not taxed on passive investment income and income from any trade or business which is related to an organization's exempt purposes.[1]

Before 1969, some exempt organizations had used their tax-exempt status to acquire businesses through debt financing, with purchase money obligations to be repaid out of tax-exempt profits; for example, as from leasing the assets of acquired businesses to the businesses' former owners.

The Tax Reform Act of 1969 provided (the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property", which is unrelated to its exempt function, is to be subject to tax in the proportion in which the property is financed by debt. In general, debt-financed property is defined as "any property which is held to produce income and with respect to which there is acquisition indebtedness" (sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

Where property "is acquired subject to a mortgage or other similar lien," the debt secured by that lien is generally considered acquisition indebtedness. The Treasury Regulations (Regs. § 1.514(c)-1(b)(2)) provide, in effect, a special rule for debts for the payment of taxes, as follows: "[I]n the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and

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[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (sec. 501(c)(7)) and voluntary employees' beneficiary associations (sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 4 percent (which the bill, as amended by the committee, lowers to 2 percent) on their net investment income (sec. 4940).

[2] There are several exceptions from the term acquisition indebtedness. For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or, under certain conditions, by gift. This exception allows the organization receiving the property to have a 10-year period of time within which to dispose of it free of tax under this provision, or to retain the property and reduce or discharge the indebtedness on it with tax-free income. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low and moderate-income housing.

payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law."

There is no similar exception for State or local governments' special assessments to finance improvements.

Reasons for change

It is common practice for State and local governmental units in some States to undertake certain improvements to land, such as roads, curbs, gutters, sewer systems, etc., and to finance these improvements either through general tax revenues or special assessments imposed on the land which the improvements are intended to benefit. The immediate funds for the improvements are provided by the sale of bonds secured by liens on the land. The bonds are then paid off either through the general tax revenues or the special assessments over a period of years.

The Internal Revenue Service has taken the position that if a lien arises from a special assessment of the type described above, as opposed to a property tax lien, the lien securing the installment payments of the assessment will constitute acquisition indebtedness, even though the installment payments are due in future periods.

The indebtedness arising from a special assessment of this sort does not appear to be the type of indebtedness that the debt-financed property provisions were intended to deal with in the 1969 Act.

Explanation of provision

The amendment provides that the indebtedness with respect to which a lien arising from taxes or a lien for special assessments made by a State or an instrumentality or a subdivision of a State will not be acquisition indebtedness until and to the extent that, an amount secured by the lien becomes due and payable and the exempt organization has had an opportunity to pay the taxes or special assessments in accordance with State law.[3] However, it is not intended that this provision apply to special assessments for improvements which are not of a type normally made by a State or local governmental unit or instrumentality in circumstances in which the use of the special assessment is essentially a device for financing improvements of the sort that normally would be financed privately rather than through a government.

In determining when a lien becomes due and payable and the exempt organization has had an opportunity to pay the necessary amount in accordance with State law, consideration must be given to the realities of the situation, and not merely the formal recitations of State law. For example, Hawaii law (sec. 67-23) provides that special assessments become "due and payable" at the end of a designated 30-day period. However, a failure to pay the assessment at the end of that period constitutes, under State law, an election to pay the assessment in installments (sec. 67-23; see sec. 67-25). Sanctions are then provided (secs. 67-27 and 67-29) in the event of failure to pay the installments when due. In such a situation, the committee intends

[3] This amendment is intended to apply also to the definition of business-lease indebtedness in section 514(g). However, since that provision is proposed to be repealed by the committee amendment, no statutory amendment is made to it.

that, for purposes of this provision, the assessment lien becomes due and payable only at the time when the relevant installment is required to be paid.

Effective date

Since this amendment is intended to reflect the intent of Congress when it amended section 514 in 1969, the amendment is to apply to all taxable years beginning after December 31, 1969.

Revenue estimate

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

g. Extension of private foundation transition rule for sale of business holdings (sec. 2514 of the bill and sec. 101(l)(2)(B) of the Tax Reform Act of 1969)

Present law

The Tax Reform Act of 1969 imposed 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 to which these taxes on "self-dealing" apply are the sale, exchange, or leasing of property (sec. 4941). The 1969 Act also added a provision to the Code which limits the combined ownership of a business enterprise by a private foundation and all disqualified persons and taxes any excess holdings which are not divested within a required period of time (sec. 4943).

The 1969 Act permits a private foundation to sell excess business holdings (held, or treated as held, by the foundation on May 26, 1969) to a disqualified person if the sales price equals or exceeds the fair market value of the property being sold. This rule was generally intended to allow private foundations and disqualified persons to disentangle their affairs and was based on the fact that in the case of many closely-held companies the only ready market for a private foundation's holdings would be disqualified persons. This rule has no terminal date. This rule (sec. 101(l) (2) (B) of the 1969 Act) also provides that prior to January 1, 1975, a private foundation could have sold business holdings which would have been excess business holdings but for the special "grandfather" rules in the statute (sec. 4943 (c) (4) and (5)) to disqualified persons.

Reasons for change

It has come to the committee's attention that, despite the 5-year transitional period in which the grandfathered excess business holdings could have been sold to disqualified persons by private foundations, some private foundations which have wished to make such a sale or other disposition have not done so. The committee believes generally that it is still desirable to encourage private foundations to divest themselves of holdings in enterprises in which disqualified persons have a significant interest provided that the foundation receives fair market value for the business holdings. However, the committee continues to believe that, in general, it is still desirable to prevent most sales, exchanges, or other dispositions between a private foundation and disqualified persons and therefore it makes these sales to disqualified persons possible without imposition of the self-dealing tax only through the remainder of this year.

Explanation of provision

The committee amendment extends the effective date of a private foundation transitional rule in the Tax Reform Act of 1969 (sec. 101 (l)(2)(B) to make that transitional rule apply to a sale, exchange, or other disposition of the "nonexcess" business holdings referred to above which takes place before January 1, 1977. This extension does not effect any of the other requirements of section 101(l)(2)(B). Therefore, for example, the requirements that such a disposition is allowed only as to property which is owned by a private foundation on May 26, 1969 (or which is considered as having been owned by a private foundation on that date), and the requirement that the foundation receive at least fair market value for the property, are not affected by this amendment.[1]

Effective date

This provision applies to dispositions occurring after the date of the bill's enactment and before January 1, 1977.

Revenue estimate

This provision is not expected to have any revenue effect.

h. Private operating foundation; imputed interested (sec. 2515 of the bill and secs. 4940 and 4942 of the Code)

Present law

Present law (sec. 4940) imposes a 4-percent excise tax on the net investment income of a private foundation. Under an earlier amendment made by the committee, the rate is to be reduced from 4 percent to 2 percent for taxable years beginning after December 31, 1976.

Present law (sec. 4942) also imposes a penalty tax on a private foundation which fails to distribute the greater of its adjusted net income or its minimum investment return. The minimum investment return is a fluctuating percentage (set by the Treasury annually to reflect current rates of return) multiplied by the average value of the foundation's noncharitable assets for the taxable year. Under another amendment made by the committee, this fluctuating percentage is to be a fixed 5 percent for the future. The adjusted net income of a foundation (for purposes of these charitable distribution rules) is its gross income (including tax-exempt interest, certain capital gains, and certain amounts treated as qualifying distributions from other private foundations) less trade or business expenses, expenses for the production or collection of income, depreciation, and cost depletion. Adjusted net income includes imputed interest.

However, the normal distribution rules applicable to private foundations do not apply to "private operating foundations". A private operating foundation is basically an organization which distributes substantially all of its income directly for the active

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[1] In addition, if a transaction under this transitional rule involves the receipt of indebtedness by the private foundation, the receipt and holding of such indebtedness is to be governed by the rules under section 101(l)(2)(C) of the 1969 Act and Regs. § 53.4941(d)-4(c)(4).

conduct of exempt activities and which meets one of three other tests. Under the first test, substantially more than one half of the assets of the foundation must be devoted directly to the activities for which it is organized or to functionally related businesses. Under the second test, the organization must normally spend an amount not less than two-thirds of the minimum investment return (i.e., two-thirds of 5 percent) to meet the current operating expenses of activities which constitute the purpose or function for which it is organized and operated. Under the third test, the organization must receive substantially all of its support from 5 or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

Reasons for change

It has come to the attention of the committee that the present rules requiring private operating foundations to distribute two-thirds of their minimum investment return may be onerous in light of the existing requirement that they distribute substantially all of their income to or for the active conduct of their charitable purposes. Further, it is often difficult to make intelligent long-run investment decisions when the minimum investment return will vary over time. Consequently, the committee believes it appropriate to reduce the minimum amount that a foundation must distribute in order to be classified as a private operating foundation to a fixed percentage of its noncharitable assets.

It has also come to the attention of the committee that there are some foundations which sold property prior to the enactment of the rules applicable to foundations in 1969 or an installment sales basis that did not call for a stated rate of interest. Prior to the enactment of the private foundation rules, whether the foundation had interest income was not relevant because the foundation paid no Federal taxes on interest income. However, with the enactment of the private foundation rules, the requirement that the operating foundation distribute income imputed to the foundation (under sec. 483) could be onerous. The foundation might either be forced to expand drastically its ongoing active program, or be forced to make one-time grants, which may cause it to fail one of the requirements for operating foundation status (spending substantially all of its income for the *active conduct* of its exempt activities, as distinguished from making grants). Consequently, the committee does not believe that it is appropriate to require a foundation to distribute income which is imputed to it because of a sale made before the Tax Reform Act of 1969.

In addition, it has come to the attention of the committee that the tax imposed (sec. 4940) on the net investment income of a private foundation has had a substantial impact on libraries and museums. Private foundations providing these types of facilities typically must spend all of their incomes to provide adequate facilities and the imposition of a tax, even at a rate of 2 percent, results in substantial curtailments of their abilities to provide library and museum facilities to the public. Accordingly, the committee believes it appropriate to remove the tax imposed on the net investment income of such organizations. However, the committee believes that, as part of this relief, a private foundation providing these types of facilities should be required to spend currently at a higher minimum level for these facilities.

Explanation of provision

The committee amendment lowers the amount which an organization must spend on its exempt functions to be considered a private operating foundation (under the second test discussed above) from two-thirds of its minimum investment return to a flat 3 percent of the average value of its assets which are not used in the active conduct of its charitable activities.

The committee amendment also changes the definition of adjusted net income for purposes of determining how much must be distributed or spent (to avoid tax under sec. 4942) to exclude income imputed to the foundation (sec. 483) in the case of sales made before the 1969 Act. Consequently, a private foundation will not be required to distribute any income imputed to the foundation. Nonetheless, imputed income is still included in the net investment income of the private foundation for purposes of the 4-percent (2-percent under the bill, as reported by the committee) tax (provided by sec. 4940).

Finally, the committee amendment provides that the excise tax on net investment income (sec. 4940) is not to be applied to a qualifying museum or library (an organization substantially all of the activities of which consist of providing library or museum facilities directly to the public on a continuing basis by holding open its building and facilities to the public on a regular schedule) for years during which it has elected to expend for these activities at least 5 percent of its "noncharitable" assets.

Effective date

The changes made by the committee amendment are to be effective for taxable years ending after the date of the enactment of this Act.

Revenue effect

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

8. Low Income Allowance (sec. 2516 of the bill and sec. 141 of the Code)

Present law

Prior to 1975, the minimum standard deduction (or low-income allowance) was $1,300. The Tax Reduction Act of 1975 raised it to $1,600 for single returns and to $1,900 for joint returns for the year 1975. The Revenue Adjustment Act of 1975 enacted a tax cut for the first half of 1976 equivalent to an increase in the low-income allowance to $1,700 for single returns and to $2,100 for joint returns.[1]

Reasons for change

The bill, as reported by the Finance Committee, makes permanent the full-year increase in the standard deduction provided in the Reve-

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[1] The specific technique used to achieve this half-year tax cut was to enact an increase in the low-income allowance one-half as large as the full-year increase referred to above but have that tax cut entirely reflected in lower withheld tax payments in the first six months of 1976. Thus, the actual minimum standard deduction now in effect for 1976 is $1,500 for single returns and $1,700 for joint returns.

nue Adjustment Act of 1975, including an increase in the low-income allowance to $1,700 for single returns and to $2,100 for joint returns. That provision of the bill also extends the general tax credit (equal to the greater of $35 per person or 2 percent of the first $9,000 of taxable income) through the first half of 1977.

The committee also believes that, even if the general tax credit is allowed to expire in mid-1977, there should not be a significant tax increase at that time for low-income people. Thus, this further committee amendment proposes to increase the low income allowance for the last half of 1977 and future years.

Explanation of provision

This further committee amendment raises the low income allowance to $1,850 for single returns and to $2,400 for joint returns for the year 1977. For 1978 and future years, the low income allowance is to be $2,000 for single returns and $2,700 for joint returns.

The Finance Committee amendment that extends the tax cuts generally provides that the withholding tables that were put into effect because of the 1975 tax cuts be used through June 30, 1977. After June 30, 1977, the Secretary of the Treasury is to issue new withholding tables to reflect the increases in the standard deduction made in this bill. These would include the full-year increase in the low income allowance in this amendment. Thus, the increase in the low income allowance for 1977 will be approximately reflected in lower withheld taxes in the last six months of 1977.

Effective date

The increase in the low-income allowance to $1,850 for single returns and $2,400 for joint returns is effective for taxable years beginning in calendar year 1977. The further increase to $2,000 for single returns and $2,700 for joint returns applies to taxable years beginning after December 31, 1977.

Revenue effect

It is estimated that this provision will decrease budget receipts by $597 million in fiscal year 1977, $2,908 million in fiscal year 1978, and $3,577 million in fiscal year 1981.

9. Equipment Leasing—Transitional Rule for "At Risk" Limitation (sec. 2518 of the bill and sec. 465 of the Code)

The bill, H.R. 10612, as amended by the committee, applies the at risk limitation to equipment leasing activities (sec. 202 of the bill). Under this provision, the losses a taxpayer may deduct from equipment leasing are limited to the amount of capital the taxpayer has actually placed at risk (and could lose) in the activity. The committee's amendment makes the at risk limitation effective for losses attributable to amounts paid or incurred in equipment leasing activities after December 31, 1975.

Upon further reflection, the committee fears that the application of the at risk limitation to equipment leasing transactions in effect before 1976 would discriminate against preexisting leases. The committee has therefore decided to provide a transitional rule for these preexisting leasing transactions.

Under this further committee amendment, the at risk rule is not to apply to equipment leasing activities where the lease was in effect on December 31, 1975. This transitional rule will apply only where the taxpayer is able to establish the existence of a legally enforceable lease in effect on December 31, 1975, pertaining to the property from which losses are incurred after that date.

It is estimated that this provision will decrease budget receipts by $1 million in fiscal year 1977 and by $2 million in fiscal year 1978, and increase budget receipts by $1 million in fiscal year 1981.

10. Architectural, Etc., Barriers to Handicapped Persons—to Include the Deaf and Blind (sec. 2520 of the bill and new secs. 190 and 263 of the Code)

This amendment clarifies the committee provision which allows taxpayers to deduct currently certain costs of removing barriers to handicapped and elderly persons from property used in their trade or business, instead of requiring the taxpayers to capitalize such expenditures. The amendment allows the deduction for the costs of removing barriers to blind and deaf persons.

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

IV. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE COMMITTEE AMENDMENT TO H.R. 10612, AS REPORTED

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 supplemental amendment to H.R. 10612. The committee estimates that the changes in fiscal year budget receipts made by this are those shown in the following table:

[In millions of dollars]

	Fiscal year—					
	TQ	1977	1978	1979	1980	1981
Revenue raising provisions	(1)	(1)	(1)	5	8	13
Revenue reducing provisions:						
Liberalized minimum standard deduction		−597	−2,908	−3,245	−3,407	−3,577
Revised estate and gift tax			−1,042	−1,367	−1,688	−2,006
Other revenue reducing provisions	−9	−54	−525	−1,499	−1,792	−2,065
Total, revenue reducing provisions	−9	−651	−4,475	−6,111	−6,887	−7,648
Net total, all provisions	−9	−651	−4,475	−6,106	−6,879	−7,635

1 Less than $5,000,000.

The Treasury Department agrees with this statement. Part II of this report contains a more detailed statement of the revenue effect of the committee amendment.

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 agrees 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.

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 amendment. The committee amendment to H.R. 10612, as amended by the committee, was ordered reported by a voice vote.

Tax expenditures

With respect to the effects of the committee amendment on tax expenditures during the next five fiscal years, the following statement is made:

In accordance with section 308(a)(2) of the Congressional Budget Act of 1974, after consultation with the Director of the Congressional Budget Office, the committee states that the changes in the levels of budget receipts for the transition quarter and fiscal years 1977 through 1981 which are shown in table 2 (in part II of this report) include the changes in tax expenditures made by these amendments.

V. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the committee amendment, as reported).