Calendar No. 680

95TH CONGRESS } SENATE { REPORT
2d Session } { No. 95–745

TECHNICAL CORRECTIONS ACT OF 1978

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 6715

APRIL 19 (legislative day, FEBRUARY 6), 1978.—Ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE
23-641 WASHINGTON · 1978

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

REPORT

[To accompany H.R. 6715]

The Committee on Finance, to which was referred the bill (H.R. 6715) to correct technical and clerical mistakes in the tax laws, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

In general, the bill contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Reform Act of 1976. These amendments were developed as a result of a review of the application of the tax law changes made by the 1976 Act. The Subcommittee on Taxation and Debt Management of the Finance Committee held public hearings on the subject of technical corrections and the subject of carryover basis on October 26, 27, 28, and 31, 1977. The Senate Finance Committee subsequently made further amendments to the bill as a result of the testimony and comments received.

The bill is divided into three parts. The first part (sec. 2) deals with technical amendments to the income tax and administrative provisions of the 1976 Act; the second part (sec. 3) covers technical, clerical and conforming amendments to the estate and gift tax provisions of that Act and also the 3-year postponement of the carryover basis provisions; and the third part (sec. 4) makes other clerical corrections, cross reference corrections, etc.

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III. GENERAL EXPLANATION OF PROVISIONS

A. AMENDMENTS TO INCOME TAX AND ADMINISTRATIVE PROVISIONS

1. Retirement Income Credit for Public Retirees Under Age 65 (sec. 2(a) of the bill and sec. 37 of the Code)

Present law

Prior to enactment of the 1976 Tax Reform Act, the retirement income credit was generally 15 percent of the first $1,524 of retirement income for each eligible individual age 65 and over, or 15 percent of the first $2,286 of retirement income for electing married couples with only one eligible spouse. Special rules provided that a taxpayer under age 65 was eligible for a retirement income credit with respect to pensions received from a Federal, State, or local government retirement system.

The 1976 Act increased the maximum credit base to $2,500 ($3,750 for joint returns if each spouse is eligible for the credit), renamed the general provision the credit for the elderly, simplified the qualification requirements, and broadened the category of eligible individual age 65 and over. Although the credit for public retirees under age 65 was also simplified and increased, most of the prior law provisions for public retirees under age 65 were retained. However, the requirement that an individual have earnings of at least $600 for 10 years was eliminated.

Reasons for change

As a result of changes made by the 1976 Act, several unforeseen problems have developed with regard to the special retirement income credit for public retirees under age 65. The laws of community property States require equal splitting of community income, including items such as earnings, pensions, and social security benefits, which are taken into account for purposes of this credit. Consequently, these laws affect both the determination of eligibility for the credit and the computation of the credit. Thus, the amount of the credit varies depending upon whether the retiree lives in a community property State or in a common law State.

In addition, the credit has been claimed by married couples with one spouse a public retiree age 65 or older and the other spouse a nonpublic retiree under age 65. This unintended situation resulted by oversight from the lack of an explicit statutory requirement that the spouse who is under age 65 be the one receiving the public retirement system income.

Furthermore, because the Tax Reform Act of 1976 eliminated the 10-years' earnings test and "retirement income" eligible for the credit continued to be defined as income from public retirement system pensions and annuities received by an individual under age 65, the credit has been claimed by taxpayers who receive such income but who are neither public retirees nor spouses of public retirees and who were not

intended to qualify for the credit. For example, some public retirees' children who receive public retirement system income because of their parents' death have claimed the credit.

The committee believes that the situations described above are inconsistent with the Congressional intent regarding the revisions of the retirement income credit rules in the Tax Reform Act of 1976. The committee therefore decided to eliminate the difference in the tax treatment of married public retirees in community property and common law States who file joint returns, to clarify the special rules for married public retirees with one spouse under age 65 and the other spouse age 65 or over, and to limit the credit explicitly and exclusively to public retirees and their spouses.

Explanation of provision

Under the bill as passed by the House and reported by the committee, the community property rules are to be disregarded in determining eligibility for the special retirement income credit and in computing the credit for public retirees and their spouses who file joint returns.[1] The bill also specifies that in order for a married couple to claim the credit the spouse under age 65 must receive public retirement income. In addition, the bill makes it clear that an individual under age 65 may qualify for this credit only if that individual or the spouse of that individual actually performed the services covered by a public retirement system.

Effective date

These provisions clarifying the eligibility rules limiting the credit to public retirees under age 65 and their spouses apply to taxable years beginning after December 31, 1975. The elimination of the difference in tax treatment resulting from differences in State laws applies to taxable years beginning after December 31, 1976.

Revenue effect

This provision will increase tax receipts by less than $1 million per year.

2. Amendments Relating to the Minimum Tax

a. Special rules for minimum tax in the case of subchapter S corporations and personal holding companies (sec. 2(b)(1) of the bill and secs. 57 and 58 of the Code)

Present law

Under the minimum tax provisions, electing small business corporations (subchapter S corporations) and personal holding companies generally determine their tax preferences in a manner similar to individuals. The 1976 Act added a new preference for individuals with adjusted itemized deductions, i.e., certain itemized deductions in excess of 60 percent of adjusted gross income.

[1] The community property rules are to be observed in the case of married couples filing separate returns (who must live apart for the entire taxable year in order to do so). They are to apply in order to avoid the confusion that would result from requiring two sets of calculations, one for the computation of tax and the other for the computation of the credit, and the inequity which would result in such case if an individual were taxed on his or her share of community retirement income without being able to claim any retirement income credit on that income.

Reasons for change

The committee believes it appropriate to clarify the minimum tax provisions in the case of small business corporations and personal holding companies.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes two technical changes to clarify the application of the minimum tax provision to subchapter S corporations and personal holding companies. The bill clarifies that the preference for adjusted itemized deductions (sec. 57(a)(1)) does not apply to subchapter S corporations and personal holding companies, since these corporations have no adjusted gross income from which to calculate this preference. In addition, the bill amends the minimum tax provisions to clarify that the capital gains preference (sec. 57(a)(9)) for a personal holding company is to be determined under the rules applicable to corporations rather than those applicable to individuals.

Effective date

The amendments made by this section apply to items of tax preference for taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

b. Exemption for controlled groups for purposes of the minimum tax (sec. 2(b)(2) of the bill and sec. 58 of the Code)

Present law

Under present law, in the case of a controlled group of corporations, the group's $10,000 amount used in computing the minimum tax exemption is allocated among the members of the group equally or according to a plan adopted by the members of the group.

Reasons for change

The 1976 Act changed the exemption for the minimum tax on corporations to the greater of $10,000 or their regular tax deduction, but did not change the manner in which the exemption could be apportioned in the case of a controlled group. Consequently, a taxpayer may be able to allocate the $10,000 amount to relatively low tax-paying members in order for the group to obtain a total exemption in excess of the exemption which the group would have if it were a single corporation.

Explanation of provision

The bill, as passed by the House and reported by the committee, would require the allocation of the $10,000 exemption amount to each of the members of a controlled group in proportion to each member's regular tax deduction.

Effective date

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

Revenue effect

This provision will increase budget receipts by less than $1 million per year.

c. *Minimum tax imposed on trusts and estates (secs. 2(b)(3), (4), and (5) of the bill and secs. 57 and 58 of the Code)*

Present law

The 1976 Act created a new preference for adjusted itemized deductions to the extent they exceed 60 percent of adjusted gross income for purposes of the minimum tax. Generally, the Act includes charitable deductions that are included as itemized deductions of trusts and estates for purposes of determining if there are "excess" itemized deductions treated as a preference under the minimum tax.

Reasons for change

The committee believes that the law should be clarified to insure that the concept of "adjusted gross income" applies to a trust or estate for purposes of the minimum tax in the same manner as to an individual. Moreover, the committee believes that the personal exemption of an estate or trust should not be treated as an itemized deduction.

Moreover, the charitable deduction, generally, is treated as an itemized deduction even though imposition of the minimum tax may actually reduce the amount passing to charity and even though the trust was not established to avoid the application of the minimum tax to the grantor since it was created prior to the 1976 Act.

Consequently, the committee believes that the charitable deduction should not be treated as an itemized deduction in the case of deductions attributable to transfers in trust made before the effective date of the adjusted itemized deduction preference. In addition, the committee believes that the charitable deduction should not be treated as an itemized deduction for minimum tax purposes where the remainder interest has been given to charity.

Finally, the committee believes that the deduction for estate taxes attributable to income in respect of a decedent should not be treated as an itemized deduction for individuals or for trusts and estates.

Explanation of provision

The bill, as passed by the House and reported by the committee, clarifies in several respects the treatment of trusts and estates under the minimum tax in the case of the preference for adjusted itemized deductions. First, the bill makes it clear that the concept of "adjusted gross income" applies to trusts and estates in basically the same manner as to individuals. Second, the bill clarifies that the personal exemption (under sec. 642(b)) is not taken into account in determining the adjusted itemized deductions. Third, the bill provides that the deduction for administration expenses and, in the case of estates, wholly charitable trusts, transfers in trust before January 1, 1976, and pooled income funds [1] the deductions for charitable contributions are treated as deductions in determining adjusted gross income. For this purpose, a transfer to a trust after January 1, 1976, from an estate of a decedent dying before that date shall be treated as a transfer in trust before January 1, 1976. The bill also provides the Internal Revenue Service with broader authority to allocate preferences between a trust or estate and its beneficiaries.

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[1] Charitable remainder trusts (Sec. 664) created after the Tax Reform Act of 1969 are generally exempt from both the income tax and the minimum tax and, consequently, no exception is necessary for these trusts.

Finally, the bill provides that the deduction for estate taxes attributable to income in respect to a decedent is not taken into account in computing the preference for adjusted itemized deductions for individuals or for trusts and estates.

Effective date

The amendments made by this section are effective as if they had been incorporated in the Tax Reform Act of 1976.

Revenue effect

This provision will increase budget receipts by less than $1 million per year.

3. Exclusion For Disability Income (sec. 2(c) of the bill and sec. 105 of the Code)

Present law

Under present law, as amended by the Tax Reform Act of 1976, the exclusion for disability income (the "sick pay" exclusion) is limited to a maximum of $5,200 a year per taxpayer. The sick pay exclusion is phased out based on the adjusted gross income of the taxpayer in excess of $15,000. Married couples claiming the sick pay exclusion are required to file joint returns.

Reasons for change

The legislative history of the 1976 Act indicates that in the case of joint returns a maximum exclusion of $5,200 would be available for each spouse but that the $15,000 income limitation would apply to total income shown on the joint return.

Because the statute uses the term "taxpayer" to mean the individual taxpayer in one instance and the married couple in another, it is not clear whether the income phaseout is to be made separately on the basis of each spouse's adjusted gross income or on their combined income. Nor is it entirely clear whether, if otherwise eligible, both spouses are entitled to one of two maximum exclusions of $5,200. The committee believes that the application of these provisions should be clarified.

Explanation of provision

To eliminate any ambiguity, the sick pay exclusion is restructured to specify that the $5,200 maximum exclusion is to be applied separately to each spouse and that the $15,000 adjusted gross income limit is to be applied to their combined adjusted gross income.

The bill as reported by the committee is the same as the House-passed bill.

Effective date

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

Revenue effect

This provision has no effect on budget receipts.

4. Net Operating Loss Carryback and Carryforward (sec. 2(d) of the bill and sec. 172 of the Code)

Present law

Present law provides varying periods for the carryback and carryforward of net operating losses by different categories of taxpayers.

For taxpayers in general, the law prior to the Tax Reform Act of 1976 allowed net operating losses to be carried back for 3 years and forward for 5 years. (A similar rule applied to insurance companies.) Regulated transportation companies were previously allowed to carry net operating losses back for 3 years and forward for 7 years.

The 1976 Act increased the loss carryfoward period by two years for those categories of business taxpayers. The two additional carryforward years were not provided, however, for categories of taxpayers which were already allowed extended loss carryback or carryover periods, such as financial institutions (which have 10-year loss carrybacks and 5-year carryforwards).

Reasons for change

The provisions of the 1976 Act inadvertently extended two additional carryover years to Banks for Cooperatives, which, like other financial institutions, were already allowed 10-years loss carryback and 5-year loss carryforward periods.

Explanation of provision

The provision corrects this oversight and eliminates Banks for Cooperatives from the categories of taxpayers which are eligible for the two additional loss carryforward years under the Tax Reform Act of 1976.

The provision is the same as in the House-passed bill.

Effective date

This amendment is effective for losses incurred in taxable years ending after December 31, 1975.

Revenue effect

This provision has no effect on budget receipts.

5. Construction Period Interest and Taxes (sec. 2(e) of the bill and sec. 189 of the Code)

Present law

The 1976 Act added a new provision (sec. 189) requiring the capitalization and amortization of real property construction period interest and taxes by individuals, subchapter S corporations, and personal holding companies. In the case of nonresidential real property, the new provisions apply where the construction period begins after December 31, 1975. However, no provision for an amortization deduction was provided with respect to construction beginning in 1976 where the taxpayer's taxable year began in 1975.

Reasons for change

The Committee believes it necessary to clarify that capitalization and amortization of construction period interest and taxes for nonresidential property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

Explanation of provision

The bill, as passed by the House and reported by the committee, clarifies that capitalization and amortization of construction period interest and taxes for nonresidential property is required only if the

construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

Effective date

This provision is effective on the date of enactment of the bill.

Revenue effect

This provision will reduce budget receipts in fiscal year 1978 by less than $1 million.

6. Tax Treatment of Certified Historic Structures (sec. 2(f) of the bill and secs. 167, 191, and 280B of the Code)

Present law

Under the 1976 Act, taxpayers are allowed to amortize over 5 years the expenses incurred in rehabilitating certified historic structures or, alternatively, to depreciate substantially rehabilitated historic structures using accelerated depreciation methods. The Act also prohibits deductions with respect to the demolition of certified historic structures and requires straight-line depreciation of any replacement structure.

Under the Act, a certified historic structure is defined as a depreciable structure listed in the National Register, a depreciable structure located in a district listed in the National Register if the Secretary of the Interior certifies that the structure is of historic significance to the district, or a depreciable structure located in a State or locally designated historic district which meets certain tests.

The 1976 Act provides that the full amount of the rapid amortization deductions claimed are to be recaptured on the sale or exchange of an historic structure (i.e., gain on the disposition, to the extent of the rapid amortization claimed, is treated as ordinary income rather than capital gain).

Reasons for change

Because of the differences in the requirements for qualifying as a certified historic structure in the case of buildings located in Federally designated historic districts and State or locally designated historic districts, the tax treatment of a building under the Act depends upon the type of historic district it is located in. The bill makes several modifications to the provisions dealing with historic structures to eliminate these unintended differences and establish more equivalent treatment for all types of historic districts and structures.

Recapture of the full amount of the rapid amortization deductions claimed with respect to expenditures for rehabilitating historic structures (as required by the Act) is the recapture rule that generally applies with respect to recapture of depreciation or amortization deductions on dispositions of personal property. In the case of real property, recapture is ordinarily limited to the extent that the depreciation or amortization deductions claimed exceed otherwise allowable straight-line depreciation. The bill conforms the recapture rules applicable to amortization of rehabilitation expenses of historic structures with the rules applicable to real estate generally.

Explanation of provision

Under the definition contained in the 1976 Act, there is no requirement that State or locally designated districts satisfy the criteria for

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listing on the National Register or that structures be of historic significance to the districts. The bill conforms the definition with respect to structures located in State or locally designated districts with the rules applicable to Federally designated districts by providing that structures in these districts are certified historic structures only where the district substantially satisfies the criteria for listing in the National Register and the Secretary of the Interior certifies that the structure is of historic significance to the district.

It is the current policy of the Department of the Interior, and the committee's intent, that buildings within registered historic districts can be certified as significant if they contribute to the significance of the district as a whole even if they do not individually qualify for listing in the National Register. For example, a turn of the century warehouse in a district identified for its significance in the commercial development of a city might well be certified as contributing to the significance of the district, based on the history of architecture of the structure and the area in which it is located.

The 1976 Act contains a special rule under which deductions are not allowed with respect to the demolition of a structure located in a registered historic district unless the Secretary of Interior certifies that the building is not of historic significance. The bill applies this special rule to structures located in State or locally designated districts. The bill also provides that, in order to obtain accelerated depreciation on a structure replacing a demolished structure which was located in a Federal, State, or locally designated historic district, certification that the structure to be demolished is not historically significant must be obtained prior to its demolition. (The provisions of the 1976 Act applicable to State and locally designated district require straight-line depreciation even if the replaced structure was not of historic significance.)

The bill applies the real property recapture rules to rapid amortization deductions claimed with respect to rehabilitations of certified historic structures. Thus, recapture is limited to the excess of the amortization claimed over the otherwise allowable straight-line depreciation (computed on the basis of the actual useful life). The bill, as reported by the committee, makes it clear that the excess amortization claimed over the otherwise allowable straight-line depreciation is a preference for minimum tax purposes (as is the case with other excess depreciation on real property).

In addition, the bill clarifies other 1976 Act law provisions dealing with historic structures. Under the 1976 Act, a taxpayer could elect either rapid amortization or accelerated depreciation with respect to the same substantial rehabilitation of a certified historic structure, but he could not elect both (i.e., the taxpayer could not claim rapid amortization with respect to the amounts spent on rehabilitation and claim accelerated depreciation with respect to the remaining basis of the property). The bill makes it clear that taxpayers may not elect accelerated depreciation (under sec. 167(o)) on a substantially rehabilitated historic structure if they have previously elected rapid amortization of rehabilitation expenditures with respect to that building. The bill also makes it clear that the required use of straight-line depreciation with respect to a structure which has been substantially altered

(other than by a certified rehabilitation) does not apply where there is a subsequent substantial alteration of the structure which is a certified rehabilitation.

The bill, as reported by the committee, would permit lessees of historic structures to claim the rapid amortization deductions with respect to expenditures incurred in rehabilitating certified historic structures in situations where the lessee holds the historic structure under a lease which, at the time the improvements are made, as a remaining term at least as long as the useful life of the improvements (but in no event less than 30 years). This provision is limited to historic structures owned by governments or exempt organizations that are "certified historic structures" because they are listed in the National Register or located in a district listed in the National Register. As in the case of dispositions by owners of historic structures claiming the benefit of the 1976 Act provisions, benefits claimed by lessees under this proposal would be subject to recapture if the lease is terminated early.

Except for the conforming minimum tax change and the leasehold provisions, the bill as reported by the committee is the same as the House bill.

Effective date

The provisions with respect to historic structures take effect as if they were included in the provisions of the Code to which they relate, as those provisions were added by the Tax Reform Act of 1976.

Revenue effect

This provision will reduce budget receipts by less than $2 million per year.

7. Deduction for Attending Foreign Conventions (sec. 2(g) of the bill and sec. 274(h) of the Code)

Present law

Prior to the 1976 Act, a deduction was allowed for traveling expenses paid or incurred to attend a foreign convention if the traveling expenses were reasonable and necessary in the conduct of the taxpayer's business and directly attributable to the trade or business. The lack of specific detailed requirements created substantial administrative problems for the IRS.

The 1976 Act provided specific rules (sec. 274(h) of the Code) limiting the deduction for expenses of attending conventions, seminars or similar meetings held outside the United States, its possessions, and the Trust Territory of the Pacific. These rules apply not only to the individual attending the convention, but also to his employer, where the employer pays the expenses. The new rules apply to conventions beginning after December 31, 1976. Under the new rules:

1. No deduction is allowed for expenses paid or incurred by an individual in attending more than two foreign conventions in any taxable year.

2. With respect to the two conventions for which a deduction is allowable, the amount of expenses that can be deducted for transportation and subsistence are limited. A deduction for transportation expenses outside the United States may not exceed coach or economy

rates charged by a commercial airline. The deduction for subsistence may not exceed the dollar per diem rate established for federal employees at the location in which the convention is held.

3. No deduction is allowed for subsistence expenses unless (a) a full day or half day of business activities are scheduled on each day during the convention, and (b) the individual attends at least two-thirds of the hours of the daily scheduled business activities or, in the aggregate, attends at last two-thirds of the total hours of scheduled business activities at the convention.

4. The taxpayer must comply with additional reporting requirements. He must furnish information indicating the total days of the trip (exclusive of the transportation days to and from the convention), the number of hours of each day that he devoted to business activities (in a brochure describing the convention, if available), and any other information required by regulations. In addition, the taxpayer must attach a statement to his income tax return signed by an appropriate officer of the sponsoring organization which must include a schedule of the business activities of each convention day, the number of hourly-related activities that the taxpayer attended each day and any other information required by regulations.

5. A deduction for the full expenses of transportation (subject to the coach or economy rate limitation) to and from the site of a foreign convention will be allowable only if one-half or more of the total days of the trip are devoted to business-related activities. The same rules for counting full days and half-days for purposes of subsistence expenses are applied.

Reasons for change

The committee believes that it is not necessary to apply the rules described above to limit the deduction otherwise available to an employer who pays the expenses of an employee to attend a foreign convention where those payments are includible in the employee's income.

Explanation of provision

Amounts includible in income

The bill provides that the limitations added by the Tax Reform Act of 1976 on the deductibility of attending foreign conventions do not apply to an employer (or other person) paying the expenses of an individual attending a foreign convention (either directly or through reimbursement) where that individual is required to include the expenses in his gross income. This exception would not apply to a payor where the amounts paid are required to be furnished by the payor to the payee on information returns or statements (i.e., Form W-2 or Form 1099) but are not furnished by the payor.

For example, where a manufacturer purchases tickets for the attendance by one or more of the employees of its dealers at a foreign convention as an incentive award and transfers the tickets to its dealers who in turn award them to certain employees, the manufacturer will not be subject to these limitations if the tickets are includible in income of the dealer and the manufacturer complies with any required information reporting. Further, the limitations will not apply to the dealer for any amount if the employee is required to include that amount in his income and the dealer complies with the applicable information

reporting requirements. Of course, the rules described above limiting deductions for foreign conventions continue to apply to the individual involved to determine the extent to which he is entitled to deduct the convention expenses.

This provision of the bill as reported by the committee is the same as the House bill except for technical changes made to clarify the information reporting requirements.

Business activities allocation rule

The 1976 Act added new provisions limiting the deduction for attendance at a foreign convention. One of the provisions limits the deductibility of the full transportation expenses to and from the site of the convention to situations where "more than one-half" of the total days of the trip (exclusive of days travelling to and from the convention) are devoted to business activities. If "less than one-half" of the total days are devoted to business activities, the transportation expenses are allocated to business activities on the basis of the percentage of days devoted to business. No specific rule is prescribed when exactly one-half of the time is devoted to business.

To correct this situation, the bill makes it clear that a portion of the transportation expense will be denied only where less than one-half of the total days are devoted to business activities.

Effective date

These provisions are effective for conventions beginning after December 31, 1976.

Revenue effect

These provisions will have no effect on budget tax receipts.

8. Deduction for Expenses Attributable to Rental of Vacation Homes (sec. 2(h) of the bill and sec. 280A of the Code)

Present law

Prior to the 1976 Act, a taxpayer was allowed a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, or for the management, conservation, or maintenance of property held for the production of income. In order to be entitled to a deduction under these provisions, it was necessary that the activity be engaged in by the taxpayer for the purpose of or with the intention of making a profit. The determination of whether an activity was engaged in for profit was made on the basis of objective standards, taking into account all facts and circumstances of each case. However, in the case of residential property held for both business and personal purposes, no definitive rules were provided to determine which expenses were atributable to the business use of the property.

The 1976 Act added a provision which, in general, provides a limitation on the amount allowable to a taxpayer for the deductions attributable to the rental of a dwelling unit if the taxpayer personally uses the unit in excess of specified periods of time during a taxable year. This new limitation applies if the taxpayer's use of the dwelling unit for personal purposes during his taxable year exceeds the greater of 14 days or 10 percent of the number of the days during the year for which the home is rented. The purpose of this limitation was to pre-

vent the conversion of nondeductible personal living expenses into deductible expenses through the use of so-called "vacation homes".

Reasons for change

The committee does not believe that the personal use of a principal residence for a portion of the taxable year should result in the disallowance of deductions for the period when the residence has been converted to rental property.

Explanation of provision

The bill as reported by the committee provides that the use of a dwelling unit as a taxpayer's principal residence (within the meaning of section 1034) is not to be treated as personal use for purposes of determining whether the deductions attributable to a "qualified rental period" are subject to the limitations added by the 1976 Act. For this purpose, a "qualified rental period" will be a consecutive period of 12 months or more, beginning or ending during the taxable year, during which the unit is rented (other than to a brother, sister, spouse, ancestor or lineal descendant of the taxpayer), or held for rental, at its fair market rental. The 12-month rental requirement does not apply if the residence is sold or exchanged before it has been rented, or held for rental, for the full 12 months.

The amendment does not apply to the deductions attributable to any period other than the "qualified rental period". In addition, the amendment does not affect the allocation of deductions attributable to the rental period.

The determination of whether a unit is a principal residence (within the meaning of section 1034) is to depend on the facts and circumstances of each particular case.

The House bill did not contain a similar provision.

Effective date

The amendment applies to taxable years ending after December 31, 1975.

Revenue effect

This provision will have a negligible effect on budget receipts.

9. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 2(i) of the bill and sec. 337 of the Code)

Present law

Under present law, if a corporation adopts a plan of complete liquidation and within 12 months thereafter distributes to its shareholders all of its assets (less those retained to meet claims), gain or loss is generally not recognized to the corporation for tax purposes with respect to property it sold during the 12-month period (sec. 337). The purpose of this provision is to provide the same tax treatment (a single tax at the shareholder level) where a corporation sells its properties and then distributes the proceeds to its shareholders as that which would be provided had the corporation first distributed the properties in kind to the shareholders who then sold the property.

Section 337 generally does not apply to a sale of assets by an 80 percent or greater controlled subsidiary which liquidates into its parent corporation. In that case, the parent corporation is not taxable on the liquidation of the subsidiary (sec. 332), and no current tax would be imposed at all if sections 332 and 337 were available at the same time.

As amended by the 1976 Act, the rule for 12-month liquidations under section 337 is available for a sale by a member of an affiliated group of corporations if every other member of the group which receives a liquidating distribution also liquidates completely.

Reasons for change

The 1976 Act did not make the new rule inapplicable to those situations where the parent (or common parent) corporation is liquidated tax-free (in whole or in part) under the one-month liquidation rule of section 333 of the Code. (Under section 333, a shareholder's gain is taxable only to the extent the corporation has accumulated earnings and profits or distributes money and stocks or securities acquired after 1953.) If both liquidation provisions (secs. 333 and 337) could apply to an asset sale followed by liquidation, the result in many cases would be that little or no current tax would be imposed on the sale proceeds. The committee believes that the nonrecognition provisions of section 337 should not apply to the sale of assets by a subsidiary when the simultaneous or ensuing liquidation of its parent falls under the liquidation rules of section 333.[2]

The 1976 amendment to section 337 applied to a sale or exchange by a corporation which is a member of an affiliated group of corporations. However, the language of the amendment did not make completely clear at what point the existence of stock ownership for this purpose is to be determined. The committee believes that this language should be clarified.

Explanation of provision

The bill, as passed by the House and reported by the committee; makes the relief provided by the 1976 Act inapplicable where the parent (or common parent) is liquidated under the one-month liquidation rules of section 333.[2] This provision will thus deny the benefit of section 337 where the corporation which sells assets is a first-tier subsidiary which then liquidates (under section 332) into its parent, after which the parent's shareholders liquidate that corporation under section 333.

If the corporation which sells property is a second-tier or lower subsidiary in a group of corporations, section 337 is also not to be available if any of the liquidations occurring at a higher point in the chain of ownership (which are otherwise required to occur) are governed by section 333.

In lieu of the reference to an affiliated group of corporations in the 1976 Act, the bill substitutes references to the selling corporation and to distributee corporations which are members of the chain of includible corporations. The selling corporation and each distributee corporation in the chain of includible corporations are required to liquidate completely within 12 months after the selling company adopts its liquidation plan. A "distributee corporation" is a corporation in the chain to which the selling company makes a liquidating distribu-

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[2] Section 337 will not be available under this provision if gain is not recognized to the shareholders in whole or part pursuant to section 333. Thus, even if part of a shareholder's gain is taxable by reason of the special limitations in section 333, section 337 will not be available to the subsidiary.

tion and each other company in the chain which in turn receives a liquidating distribution by reason of the liquidation of its transferor. The term "chain of includible corporations" is intended to have the same meaning as that term has in section 1504(a), which generally defines an affiliated group.[3] The reference to chains of includible corporations is subsituted for the existing reference to an affiliated group in order to make clear that the liquidation requirements of the 1976 amendment apply only to those corporations which directly or indirectly own a stock interest in the selling company (other than through the common parent.)[4]

The definition of distributee corporation is also intended to make it clear that no corporation in which the selling company owns stock is required to liquidate under this provision. That is, the liquidation requirements apply only to corporations in the chain above the level of the selling company in the direction of the common parent; a subsidiary of the selling company which owns no stock of the selling company would not have to liquidate.

The definition of distributee corporation also makes clear that the companies required to liquidate are determined by reference to the date on which a liquidating distribution is made rather than the date on which the distribution is received (which in some cases might be later than the date on which the transferor transmitted the distribution). The 1976 amendment was subject to a possible interpretation that a corporation in the chain which received a liquidating distribution from another corporation in the same chain might not be required to liquidate if the distributee actually received the distribution beyond the 12-month period.

The definitions in the bill also deal with changes in stock ownership of the selling company (or of another company in the same chain) after the selling company adopts its plan or sells assets and before it begins making distributions in liquidation. If the selling company is a member of a chain of includible corporations at the time the selling company makes a liquidating distribution, each corporate member of the chain receiving a liquidating distribution at that time must itself liquidate completely. Thus, for example, if a corporation is owned by one or more individuals at the time it adopts a section 337 plan

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[3] An includible corporation is determined under sec. 1504(a) by reference to 80 percent or greater ownership of a corporation by the common parent or one or more other includible corporations. To illustrate the operation of this definition, assume that a common parent, P, owns all the stock of sister subsidiaries S–1 and SS–1. S–1 owns 90 percent of the stock of a second-tier subsidiary, S–2. SS–1 owns the remaining 10 percent of the stock of S–2 and all the stock of its subsidiary, S–2. If S–2 adopts a plan under section 337 and sells its assets, the corporations which must liquidate under this provision (in addition to S–2) are S–1, SS–1, and P.

The existence of an includible corporation continues to be determined without regard to the exceptions contained in section 1504(b).

[4] For example, if a common parent, P. owns all the stock of S–1, which in turn owns all the stock of S–2, which in turn owns all the stock of S–3, section 337 can apply to a sale of property by S–3 if the selling company liquidates into S–2. S–2 liquidates into S–1, S–1 liquidates into P, and P liquidates completely within 12 months after S–3 adopted its plan. If P had owned a separate group of subsidiaries, none of which owns any stock in the companies just described. none of the subsidiaries in the separate chain would be required to liquidate in order for section 337 to benefit S–3's sale. P's shareholders would be required, however, to receive P's stock in the parallel chain as part of P's liquidation.

and sells it assets, but is 80 percent or more owned by a corporate shareholder at the time it begins making distributions in liquidation, the corporate shareholder must liquidate completely even though that shareholder did not own stock of the selling company at the time the plan was adopted or the assets sold.

Even if a corporation which receives a liquidating distribution was not a member of the chain at the time the selling company liquidated, a "distributee corporation" must also liquidate completely within 12 months after the selling company adopted its plan. For example, assume that several individuals own all the stock of corporation B which in turn owns all the stock of corporation C. C adopts a section 337 plan on January 1, 1978, shortly thereafter sells some or all of its assets, and makes a liquidating distribution to B on June 1 of the same year. On July 1 of the same year unrelated corporation A purchases all the stock of B. On September 1 of the same year B makes a liquidating distribution to A. Under the bill, section 337 will apply to C's gain on its sale of property only if A also liquidates completely within the 12 month period starting on January 1, 1978. Even though A and C were never in the same affiliated group or chain of includible corporations (because C had liquidated before A acquired B's stock). A must liquidate because within the 12-month period it became a distributee corporation (as described above).

Effective date

The amendments made by the bill apply to sales or exchanges pursuant to a plan of complete liquidation adopted after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

10. Transactions Involving Two or More Investment Companies (sec. 2(j) of the bill and sec. 368(a)(2)(F) of the Code)

Present law

Under present law, as amended by the 1976 Act, tax-free "reorganization" treatment is denied to investment companies ("swap funds") and their shareholders and security holders if such company (or companies) owns an undiversified portfolio of stock or securities before the exchange. Under an exception, this disallowance of tax-free reorganization treatment does not apply where "substantially all" the stock and securities was held by the same persons in the same proportions. Thus, under the swap fund rules, a realized loss can be created and deducted by a corporation or its shareholders and security holders where it results from an exchange among two or more "commonly-controlled" investment companies (if one of them has an undiversified portfolio), unless the corporate parties to the exchange are owned by substantially the same persons in the same proportions.

Reasons for change

The committee believes that deductions of losses resulting from an otherwise tax-free reorganization between one or more undiversified investment companies should be disallowed where more than 50 percent of the value of the stock of the corporate parties to the exchange is owned directly or indirectly by the same person.

Explanation of provision

Under the committee's bill, a deduction of a loss resulting from an otherwise tax-free reorganization between one or more undiversified investment companies would be disallowed if more than 50 percent in value of the outstanding stock of the corporate parties to the exchange are owned, directly or indirectly, by or for the same individual. The purpose of this rule is to prevent the deduction of what are essentially artificial losses. This result will be achieved by applying the provisions of section 267(b)(3) of the Code to a loss realized by an investment company which is a party to the exchange. However, the committee intends the provisions of section 267(b)(3) to apply to such transaction where one or more of the corporate parties is a so-called "investment company" immediately before the transaction. This provision will not affect the tax-free treatment of gains where substantially all of the stock of the investment company is owned by the same persons in the same proportions.

In addition, the committee's bill modifies the definition of an investment company to parallel the percentage requirements for portfolio diversification which are otherwise applicable to reorganization of two or more investment companies. In addition, the bill adds the definition of the term "securities". Finally, the bill makes several changes in the language of the "reverse acquisition" rule in order to clarify the computation of the amount which shareholders will be deemed to realize in transactions to which this special rule applies.

Effective date

These changes will apply as if included in the 1976 Act except that the provisions relating to the nonrecognition of losses and to the treatment of commodity futures contracts as securities will apply to transfers after September 26, 1977.

Revenue effect

This provision will increase budget receipts by less than $1 million per year.

11. At Risk Provisions (sec. 2(k) of the bill and sec. 465 of the Code)

Present law

The 1976 Act contained a special effective date provision for application of the at risk provision (sec. 465) to equipment leasing activities. Inadvertently, a cross-reference referred to a provision describing farming activities while it should have referred to leasing activities.

In addition, the at risk provision provides generally that the amount of any loss (otherwise allowable for the taxable year) which may be deducted in connection with any one of certain activities (involving farming, oil and gas, motion pictures or video tape, or equipment leasing) cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each such activity at the close of the taxable year. The intent of the provision was to treat amounts disallowed by reason of the at risk provision in the prior taxable year in the same manner as amounts paid or accrued from the activity to which section 465 applies in the current taxable year.

The definition of loss for a taxable year (sec. 465(d)) refers to the excess of the deductions allowable for the taxable year (determined without regard to the at risk provision) over the income received or accrued by the taxpayer during the taxable year from the activity. Thus, the provision is unclear as to whether the deductions entering into the computation of the loss for the current year include losses from prior years which, by virtue of section 465(a), were disallowed as deductions in those prior years.

Reasons for change

To clarify the computation of the loss for any current year, the committee believes it to be appropriate to clarify the provisions of section 465(d) as to the treatment of losses disallowed in prior years solely by reason of the at risk provision (sec. 465(a)).

Explanation of provision

The bill, as passed by the House and reported by the committee, amends subparagraph (A) of section 204(c)(3) of the Tax Reform Act of 1976, to refer to the special effective date provision for the application of the at risk provision to equipment leasing activities. This is a clerical change.

The bill also amends the definition of loss for the taxable year (sec. 465(d)) to clarify that the deductions entering into the computation of loss for the taxable year include losses from prior years which, by virtue of section 465(a), are treated as deductions in the current year.

Effective date

The amendments made by this section are effective as of October 4, 1976 (the date of enactment of the 1976 Act).

Revenue effect

These provisions will have no effect on budget receipts.

12. Amendments Relating to the Use of Accrual Acounting for Farming (sec. 2(l) of the bill and secs. 447 and 464 of the Code)

a. Automatic ten-year adjustment period for farming corporations and partnerships required to use accrual accounting (sec. 2(l)(1) of the bill and sec. 447 of the Code)

Present law

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act generally requires that certain farming corporations use an accrual method of accounting and capitalize preproductive period expenses. Exceptions are provided for subchapter S corporations, family corporations, certain small corporations, and taxpayers in the trade or business of operating a nursery. The Act also requires that certain farming partnerships (in which "nonexcepted" corporations are partners) use an accrual method of accounting and capitalize preproductive period expenses.

A transitional rule (sec. 447(f)) provided that a taxpayer who is required by this section to change its method of accounting can, except as otherwise provided in regulations, take the accounting adjustments required by this change into account over a ten-year period.

Reasons for change

The 1976 Act requires certain corporations and partnerships to change from the cash method of accounting to an accrual method of accounting and to capitalize preproductive period expenses which, under prior law, could have been deducted currently. Changes in method of accounting of this sort often require significant adjustments which, unless spread over a number of years, could materially increase a taxpayer's tax burden in the year the method of accounting is changed. To ease this problem, the 1976 Act provided generally that such adjustments could be spread over a 10-year period. However, it is unclear how the adjustments are to be made in certain cases where either the taxpayer had not been in existence or had been using a different method of accounting during the 10 years prior to the year of change or where the taxpayer's future life was limited to fewer than 10 years from the year of change.

The committee believes that it is equitable to allow a taxpayer who has been in existence for less than 10 taxable years, to be able to spread the adjustments over a period equal to 10 taxable years (or if lesser, its stated future life, if one is specified).

Explanation of provision

Under the bill as passed by the House and reported by the committee, a corporation or partnership which is required by section 447 to change to an accrual method of accounting with capitalization of preproductive period expenses is able to take the accounting adjustments required by such change into account over a 10-year period except in those situations where a corporation or partnership has a stated future life of less than 10 years. In cases where the corporation or partnership has a stated future life of less than 10 years, these adjustments may be taken into account ratably over its stated future life.

The determination as to the stated future life of an organization is to be made as of the first day of the first taxable year for which an accounting change is required. Thus, for instance, if a partnership agreement contains a provision limiting the future life of the partnership to a stated period and also contains an agreement whereby such partnership agreement may be amended to extend the life of the partnership, the provision to permit an extension is to be disregarded if the partnership agreement has not been amended to provide for such extension as of the first day of the year of change.

Effective date

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

b. Automatic 10-year adjustment for farming syndicates changing to accrual accounting (sec. 2(l)(2) of the bill, sec. 464 of the Code)

Present law

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act provides limitations on certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer, or other supplies until the supplies are used or consumed, (2) to capitalize or inventory certain preproductive period expenses of poultry, and (3) to capitalize preproductive period expenses of orchards and vineyards.

No transitional rules were provided for farming syndicates affected by this provision. Thus, if a farming syndicate wishes to change to an accrual method of accounting with capitalization of preproductive period expenses, it must, under the ordinary rules, obtain the consent of the Internal Revenue Service, and the Internal Revenue Service would have broad discretion to determine the period (if any) over which the farming syndicate would have to spread the adjustments required by the change in accounting method.

Reasons for change

The committee understands that certain farming syndicates may wish to elect to use an accrual accounting method with capitalization of preproductive period expenses. Since this method of accounting more accurately matches income and expenses than the cash method of accounting (even as modified by the farming syndicate rules), the committee believes that it is appropriate to provide a generous transition period to encourage farming syndicates to change voluntarily to this method. In addition, certain farming syndicates have been able to take advantage of a 10-year transitional rule provided in section 447 of the Code because they are partnerships with corporate general partners. However, other farming syndicates with individuals as general partners have been ineligible to use this transitional rule because section 447 of the Code does not require them to change to an accrual method of accounting.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that, if a farming syndicate was in existence on December 31, 1975 (the date immediately prior to the effective date of the farming syndicate provisions of the 1976 Act), and the syndicate elects to change to an accrual method of accounting with capitalization of preproductive period expenses (described in section 447(b)) for a taxable year beginning before January 1, 1979, the change of method of accounting will be treated as having been made with the consent of the Service and the net amount of the accounting adjustment required to be taken into account shall be spread over a period of 10 taxable years starting with the year of change (or ratably over the syndicate's remaining taxable years where the syndicate has a stated future life of less than 10 years).

This provision is to be available only if the farming syndicate changes to an accrual method of accounting with capitalization of the preproductive period expenses referred to in section 447(b). It is not intended to apply to a taxpayer seeking to change to the "annual accrual method of accounting" under section 447(g).

In determining whether a farming syndicate (such as a partnership) has a stated future life of less than 10 years, and in determining the number of years of such stated future life, reference is to be made to the circumstances as of the first day of the year of change of the accounting method. Thus, for instance, if a partnership agreement contains a provision limiting the future life of the partnership to a stated period and also contains an agreement whereby such partnership agreement may be amended to extend the life of the partnership for a further period, the provision to permit an extension will be disregarded if the partnership agreement has not been amended to provide for such extension as of the first day of the year of change.

Effective date

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

Revenue effect

This provision will reduce budget receipts by less than $2 million per year.

c. Extending family attribution to spouses in the farming syndicate rules (sec. 2(l)(3) of the bill, sec. 464 of the Code)

Present law

Prior to the 1976 Act, any taxpayer engaged in the trade or business of farming was entitled to use the cash method of accounting for such business and to deduct currently costs of a nature which, for other businesses, would be either included in inventory or capitalized.

The 1976 Act provided limitations on certain types of deductions for farming syndicates. These limitations generally require farming syndicates (1) to defer deducting the cost of prepaid feed, seed, fertilizer or other supplies until the supplies are used or consumed, (2) to capitalize or inventory certain costs of poultry, and (3) to capitalize preproductive period expenses of orchards and vineyards.

In general, farming syndicates were defined to include (1) any partnership or other noncorporate enterprise engaged in farming if interests in the business were required to be registered with a Federal or State securities agency and (2) any partnership or other noncorporate enterprise engaged in farming if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. Generally, limited entrepreneurs and limited partners are individuals who do not actively participate in management of the activity. Certain interests in farming enterprises are not treated as interests held by limited partners or limited entrepreneurs if the interests are attributable to active participation in farm management or certain other qualifications are met by an individual or certain family members of that individual. For purposes of this rule, a family is determined by reference to the grandparent of an individual, and family members are members of the grandparent's family. However, under

the language of this provision, the individual's spouse and the spouses of other family members other than the grandparent are not included as family members.

Reasons for change

The omission of spouses of members of a family in the family member rules of the farming syndicate provisions was a technical oversight.

Explanation of provision

This provision expands the family member rules of the farming syndicate provisions to cover the spouses of family members. The provision is the same as the House bill.

Effective date

This provision is effective as of October 4, 1976 (the date of enactment of the 1976 Act).

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

13. Extensions of Certain Provisions to Foreign Personal Holding Companies (sec. 2(m) of the bill and secs. 189, 280, and 465 of the Code)

Present law

The 1976 Act contained a number of provisions to limit taxpayers' use of tax shelters. One of these provisions provides that certain real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a period of years, generally 10 years (sec. 189). Another section provides that the amount of any loss (otherwise allowable for the year) which may be deducted in connection with any one of certain activities (involving farming, oil and gas resources, motion picture films or video tapes, or equipment leasing) cannot exceed the aggregate amount with respect to which the taxpayer is at risk in each activity at the close of the taxable year (sec. 465). A third person requires the capitalization of the costs of producing motion pictures, books, records, and other similar property and permits the deduction of these capitalized costs over the life of the production activity (sec. 280). All of these provisions apply to individuals, estates, trusts, subchapter S corporations and personal holding companies. These provisions do not apply to other corporations.

In general, these provisions were applied only to situations where the deductions would reduce the taxable income of individuals (or estates and trusts). However, these rules were also made applicable to personal holding companies, which are certain domestic corporations established to receive and hold investment income or compensation of its shareholders in order to shield that income from the higher individual tax rates that would apply if the income were received by the shareholders.

Reasons for change

Since a foreign personal holding company can be used to shelter income from the individual income tax rates, the committee believes the three tax shelter provisions discussed above should also apply to foreign personal holding companies.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes the provisions of the Internal Revenue Code of 1954, relating to the amortization of real property construction period interest and taxes (sec. 189), the capitalization of costs of producing motion pictures, books, records and other similar property (sec. 280), and the "at risk" provisions (sec. 465) applicable to foreign personal holding companies in the computation of their taxable income.

Effective date

These provisions are generally effective for taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by less than $2 million per year.

14. Definition of Condominium Management Association (sec. 2(n) of the bill and sec. 528 of the Code)

Present law

The Tax Reform Act of 1976 added a provision to the Internal Revenue Code (sec. 528) which permits certain homeowners associations to elect to be treated as tax-exempt with respect to their exempt function income. The homeowners associations which are eligible to make this election include condominium management associations and residential real estate management associations which satisfy certain statutory requirements. Under the 1976 Act, the definition of a residential real estate management association requires that substantially all of the lots or buildings of the subdivision, development, or similar area which the association serves "may only be used by individuals for residences" (sec. 528(c)(3)), but similar requirements for condominium management associations require that the units of the condominium project be "used as residences" (sec. 528(c)(2)).

Reasons for change

In order to make it clear that no distinction was intended with respect to the differences in definitions between a condominium management association and a residential real estate management association, the committee believes it is appropriate to conform the definitions of the two types of homeowners associations.

Explanation of provision

The bill, as passed by the House and reported by the committee, conforms the definitions of condominium management association with that of residential real estate management association by providing that all of the units of a condominium project be "used by individuals for residences." Thus, the bill makes it clear that no distinction was intended to be made between the two types of associations in this respect.

Effective date

The amendment is applicable to taxable years beginning after December 31, 1973.

Revenue effect

This provision has no effect on budget receipts.

15. Personal Holding Companies—Definition of "Individual" for Stock Ownership Test (sec. 2(o) of the bill and sec. 542 of the Code)

Present law

Under present law, a tax is imposed on the undistributed income of a "personal holding company." Basically, a "personal holding company" is a corporation which derives most of its income from certain passive sources and 50 percent or more of whose stock is owned by 5 or fewer individuals.

Under the law prior to the Tax Reform Act of 1976, an organization or trust organized or created before July 1, 1950, would not be counted as an individual in determining whether a corporation constituted a personal holding company if the organization or trust owned all of the common stock and at least 80 percent of the other stock of the corporation. The 1976 Act deleted this last exception as part of the "deadwood" provisions of that Act.

Reasons for change

The "deadwood provisions" in the 1976 Act were designed to simplify the tax law by removing from the Internal Revenue Code those provisions which are no longer used in computing current taxes or are little used and of minor importance. In the case of this provision, it has come to the attention of the committee that at least one company still comes within the provision eliminated under the deadwood provisions. Since the definition of personal holding company was modified by the "deadwood" provisions of the 1976 Act pursuant to the belief that no taxpayer any longer qualified under its terms, the committee believes it to be appropriate to reinstate the exception.

Explanation of provision

The amendment reinserts the provision of prior law that was deleted by the deadwood provisions of the 1976 Act, but it is accomplished by changing the effective date rather than reinserting the provision in the Code.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

16. Gain on Sale of Certain Property Transferred in Trust (sec. 2(p) of the bill and sec. 644 of the Code)

Present law

The 1976 Act added a new provision (sec. 644) which taxes a trust at the transferor's rate brackets where the trust disposes of an asset within 2 years of its transfer to the trust by the transferor. The statute applies to any gain *realized* by the trust, even if that gain would not be *recognized* by the trust under other provisions of the Code that provide for tax-free treatment in certain situations. Thus, for example, the new provision apparently would apply to stock exchanged in a tax-free reorganization of a corporation by the trust if the stock had been transferred to the trust less than 2 years before the reorganization.

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In addition, the application of the new provision is unclear where the transferor has items, such as charitable contributions, net operating losses, and capital losses, that are carried back or over from the transferor's taxable year in which the property was sold by the trust to another year.

Also, where the transferor incurs a net operating loss within three years after the year in which the transferred property was sold, the transferor may be permitted to carry back the net operating loss and thus reduce his taxable income for the year in which the transferred property was sold. In such a case, the trust would apparently be entitled to file a claim for refund since its tax under this new provision is based on the transferor's rate bracket.

Generally, the new provision applies regardless of whether the trust elects to report income under the installment method for reporting gain on a sale or exchange. However, the "includible gain" does not include any portion of an installment received by the trust after the death of the transferor.

Reasons for change

The committee believes that the new provision should only apply to gains recognized by the trust. However, the committee also believes that the new provision should apply to the property received in a tax-free exchange to the same extent that the provision applied to the property transferred in the tax-free exchange.

In addition, the committee believes that it should not be possible for both the trust and the transferor to obtain the benefit of an item through the carryover of that item to another year of the transferor.

Moreover, because of the administrative difficulties which would arise if the trust is permitted to take into account a net operating loss carryback of the transferor, the committee believes that the tax under the new provision should be computed without regard to any net operating loss carryback of the transferor.

Finally, due to the fact that where installment reporting of gain on the sale or exchange of property is elected and installment payments with respect to the purchase price are made in two or more years, some question has arisen as to the treatment of installment payments made after the two year period referred to in section 644.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the new rule applies only to gains recognized by the trust under the normal rules governing tax-free transactions. However, the bill provides that the new provision will apply to property received in a tax-free exchange to the same extent that it would have applied to the property given up in the tax-free exchange.

In addition, the bill provides that the tax computation under the new provision is to be determined without regard to any loss or deduction which is carried (either back or forward) to another year of the transferor. For example, assume that the transferor had $10,000 of ordinary business income in the year in which the transferred property is sold and that the includible gain on the transferred property was $20,000. If the transferor had a long-term capital loss in 1977 or a long-term capital loss carryover to that year of $5,000, then $1,000 of the loss would be disregarded because it is carried over to the transferor's

following taxable year ($5,000 total long-term capital loss reduced by $4,000 which is the amount considered used to determine to a maximum $2,000 capital loss deductible against ordinary income for 1977 ($3,000 for 1978) at 50 percent of the long-term capital loss.)

In addition, the bill provides that the tax under the new provision is to be computed without regard to any net operating loss carrybacks to the transferor's taxable year which are used to determine the applicable tax rate. However, the tax is computed with regard to net operating loss carryovers from prior years and any net operating loss for the year of sale, to the extent no carryback or carryover arises from that year. For example, assume the same facts above, except that the transferor has a net operating loss carryforward from prior years of $5,000 and no capital losses. In this case, the tax under the new provision is computed by taking the entire amount of the $5,000 net operating loss deduction into account since none of the net operating loss deduction can be carried forward to another year of the transferor. However, if the net operating loss carryforward were $12,000, then the tax under the new provision would be computed by allowing a net operating loss deduction of $10,000 since $2,000 can be carried over to another year of the transferor. Where, however, the year of sale is the last year to which a net operating loss deduction can be carried (generally 7 years), then the tax under the new provision is computed with regard to the full net operating loss deduction since any excess net operating loss deduction of the transferor cannot be carried over to another year of the transferor.

Finally, in the case of installment sales, each installment is taxed at the grantor's tax rate if the installment sale occurred within the two year period after the transfer to the trust. In other words, the provision applies where a trust elects to report income under the installment sale method as if each installment were a separate sale or exchange of property to which the provision applied, without regard to the two year rule.

The bill also removes a conforming amendment in the capital gains throw-back rule which was repealed by the 1976 Act since the enactment of the new provision (sec. 644) removed the need for such a conforming amendment.

Effective date

The provisions generally apply to transfers in trust made after May 21, 1976. The removal of the conforming amendment in the capital gains throw-back rules is effective on October 4, 1976 (the date of enactment of the 1976 Act).

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

17. Allowance of Foreign Tax Credit for Accumulation Distributions (sec. 2(q) of the bill and secs. 665 and 667 of the Code)

Present law

Prior to the 1976 Act distributions from trusts of accumulated income were taxed in substantially the same manner as if the income were distributed when earned. The 1976 Act made several modifications in the manner in which accumulation distributions are taxed. Un-

der the Act accumulation distributions are thrown back to three of the five preceding years, excluding those years with the highest and lowest incomes, and are taxed at the beneficiary's rates for those years with a credit for any U.S. taxes imposed on the trust. The 1976 Act does not permit refunds of excess taxes paid by the trust. In addition, the accumulation distributions generally do not retain in the hands of the beneficiary the character of the income from which they were distributed.

Reasons for change

The modifications made by the 1976 Act to the taxation of accumulation distributions leave unclear whether beneficiaries may claim a credit with respect to foreign taxes paid by the trust which are allocable to accumulation distributions and, if such a credit is allowed, how it is computed. The bill provides rules under which beneficiaries may claim a tax credit with respect to foreign taxes allocable to accumulation distributions so that the treatment of current and accumulation distributions are substantially similar in this regard.

Explanation of provision

The bill, as passed by the House and as reported by the committee, adopts two separate rules: one for distributions from domestic accumulation trusts, and the other for distributions from foreign accumulation trusts.

With respect to distributions from domestic accumulation trusts, the bill as reported by the committee has substantially the same effect as the provision contained in the House bill. However, instead of amending the definition of "taxes imposed on the trust" (sec. 665(d)) to include foreign income taxes as well as Federal income taxes allocable to the distribution, the committee's bill simplifies the operation of the credit mechanism by defining "taxes imposed on the trust" as the gross Federal income tax before credits allocable to the distribution. Thus, the benefit of any foreign tax credit, investment credit, or any other credit allowed under subpart A of part IV of subchapter A of the Code (secs. 31 through 45) claimed by the trust in a prior accumulation year is flowed through to the beneficiary when the accumulated income of such year is distributed. The credits are not passed through as identifiable amounts, but rather comprise a portion of U.S. tax imposed on the trust which may be offset against the partial tax on the distribution. Since any applicable limitations on the credits were computed and applied at the trust level, no further limitations (other than the denial of refund for taxes imposed on the trust in excess of the partial tax) are imposed. There is no requirement under the committee's bill that the beneficiary elect the foreign tax credit for the year of distribution.

A separate rule is provided under which foreign income taxes allocable to accumulation distributions from foreign trusts are allowed as a credit in computing the partial U.S. tax on the distribution. The rule reaches the same basic result as the rule contained in the House bill, except that, as explained below, the foreign tax credit limitations are imposed in the three computation years rather than the distribution year. The limitations are imposed in the computation years because the partial tax is computed with reference to the facts of the computation years, not the distribution year.

Under the committee's bill the definition of "taxes imposed on the trust" (sec. 665(d)) is amended to include, in the case of foreign trusts, the foreign taxes paid or accrued by the trust that are properly allocable to the accumulation distribution. As a consequence, the amount of such taxes is deemed to have been distributed to the beneficiary and is includible in his gross income along with the actual trust distribution (secs. 666(b) or (c) and 667). As in the case of a domestic trust, a partial tax is computed with respect to the total distribution using the throwback rules (sec. 667(b)). In computing the partial tax in the case of a foreign trust, however, the deemed distributed foreign income taxes included in income in a computation year are allowed, subject to the foreign tax credit limitations, as a credit against the increase in tax for that year. In contrast, U.S. taxes imposed on the trust are allowed as an offset against the partial tax on the distribution in the distribution year (determined on the basis of the average increase in tax for the three computation years).

The foreign tax credit limitations are applied in computing the partial tax in the case of distributions from foreign trusts because, in contrast to domestic trusts, foreign trusts are not generally subject to U.S. tax on the income when accumulated, and thus the foreign tax credit limitations have not been applied at the trust level. Foreign taxes in excess of these limitations are not available for carryover or carryback (this corresponds to the treatment of U.S. taxes attributable to accumulation distributions; they are allowed as offsets against the partial tax, but no carryovvers are allowed for any excess).

The limitations on the foreign tax as a credit against the increase in tax in each of the computation years are applied separately to the accumulation distribution as compared with other items in the beneficiary's return for such year. Further, foreign taxes included in income in the computation year by reason of the accumulation distributions may be claimed only against the increase in tax for the computation year. The separate limitations on the trust distribution are computed in the same manner as the separate limitations on foreign taxes related to foreign source interest and DISC dividends. That is, the numerator of the limiting fraction is the portion of the income added to the beneficiary's taxable income for the computation year which is from foreign sources (or which is foreign oil-related income, interest income, or DISC income) ; the denominator is the sum of the worldwide taxable income of the beneficiary for the computation year and the income added to his taxable income for purposes of computing the increase in tax; and the tax to which the fraction is applied is the sum of the total U.S. tax of the beneficiary for the computation year and the increase in tax for that year. The items of income, deduction, and credit of the trust retain their character and source to the extent necessary to apply these rules.

If the beneficiary elected the foreign tax credit on his return for a computation year, he must credit the foreign taxes deemed distributed by the trust in computing the increase in tax for that year. If the beneficiary did not elect the foreign tax credit on his return for the computation year, he may either treat the foreign tax imposed on the trust as a deduction or a credit in determining the increase in tax for that computation year. If the beneficiary deducted other foreign taxes in the computation year, he will not, merely by reason of the throw-

back rules, be required to amend his return for that year and recompute the tax as if the foreign taxes had been claimed as a credit. However, if the beneficiary deducted foreign taxes on his return for the computation year but elects to credit foreign taxes included in the accumulation distribution in computing the increase in tax for that year, the increase in tax is the difference between (i) the tax on the beneficiary's taxable income for that year, computed by deducting foreign taxes, and (ii) the tax on the sum of the beneficiary's taxable income, plus the amount added under section 667(b)(1)(C), plus the amount of foreign taxes originally deducted for that year, computed by crediting both the foreign taxes imposed on the trust and the foreign taxes paid or accrued by the beneficiary in the computation year.

A special rule is provided for the application of the foreign loss recapture rules (sec. 904(f)) to accumulation distributions from foreign trusts. If the beneficiary sustained an overall foreign loss (or foreign oil-related loss) in a taxable year prior to the distribution year, the portion of the accumulation distribution which is out of foreign source income (or foreign oil-related income) of the trust will be recaptured (i.e., treated as U.S. source income for purposes of computing the credit in the computation year) to the extent that the loss has not been recaptured (i) in intervening years, or (ii) against any foreign source taxable income (or foreign oil-related income) of the beneficiary in the distribution year other than the accumulation distribution. The recapture will apply to the entire amount of the foreign source income included in the accumulation distribution (the 50 percent of foreign source taxable income limitation of sec. 904(f)(1)(B) will not apply). By recapturing the unused loss against the accumulation distribution, the trust income added to each of the computation years is treated as income from U.S. sources in the proportion that the loss recaptured against the accumulation distribution bears to the total accumulation distribution (including the foreign taxes deemed distributed).

The application of this rule is illustrated by the following example. A beneficiary of a foreign accumulation trust receives a distribution in 1980 of $20,000 of foreign source income. The foreign tax paid or accrued by the trust that is properly allocable to such income is $4,000. The three computation years chosen after application of section 667(b)(1)(C) are 1975, 1977, and 1978. The beneficiary incurred an overall foreign loss in 1979 of $10,000. He does not have any foreign source income in 1980 other than that from the trust distribution. The amount to be added to taxable income in each computation year is $12,000 (the sum of the actual distribution ($20,000) plus the deemed distributed taxes ($4,000) divided by the number of accumulation years (2)). The foreign loss recapture rules require that 10/24 ($10,000 recaptured loss over the $24,000 total distribution) of the income added to each computation year be resourced as U.S. source income. Thus, $5,000 of the income added to each computation year is U.S. source and $7,000 is foreign source for purposes of computing the foreign tax credit limitations in those years.

Effective date

The amendments made by this provision apply generally to distributions made in trust taxable years beginning after December 31, 1975.

However, the amendment coordinating the loss recapture rules with the accumulation distribution amendments applies to losses sustained in taxable years of beneficiaries beginning after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

18. Source and Character of Accumulation Distributions from Trusts (sec. 2(r) of the bill and sec. 667 of the Code)

Present law

The 1976 Act substantially changed the treatment of distributions of income accumulated by trusts in years prior to the distribution. One of those changes is that distributions of previously accumulated income, other than those attributable to tax-exempt interest, do not retain in the hands of the beneficiary the character of the income from which they were distributed. In the case of distributions of previously accumulated income to nonresident aliens and foreign corporate beneficiaries, the elimination of the characterization rules leaves unclear how to determine the amount, if any, of U.S. withholding tax to be imposed on the distribution.

Reasons for change

Because of the necessity of knowing the character of the income in applying the U.S. withholding tax on distributions to nonresident aliens and foreign corporations, the committee believes that the character of income should be retained in the case of accumulation distributions to these persons.

Explanation of provision

The bill, as passed by the House and reported by the committee, reinstates the rules that applied prior to the 1976 Act (under sec. 662(b)) with respect to accumulation distributions to nonresident aliens and foreign corporations. Thus, distributions by a trust of previously accumulated income made to nonresident aliens and foreign corporate beneficiaries will retain the character of the income from which the distributions are made.

Effective date

The amendment is effective for accumulation distributions made in taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

19. Limitation on Allowance of Partnership Losses in the Case of Nonrecourse Loans (sec. 2(s) of the bill and sec. 704(d) of the Code)

Present law

The Tax Reform Act of 1976 provided, in general, that for purposes of the limitation on allowance of partnership losses, the adjusted basis of a partner's interest is not to include any portion of any partnership liability with respect to which the partner has no personal liability.

However, two exceptions to this rule were provided. Under the first exception the rule does not apply with respect to any activity to the extent that the specific at risk rule is applicable (sec. 465). Under the second exception, the rule does not apply to "any partnership the principal activity of which is investing in real property (other than mineral property)."

Reasons for change

The application of the exception for real estate activities under the partnership at risk rules (sec. 704(d)) is uncertain because the terms "investing in real property" and "principal activity" are ambiguous. Therefore, the committee decided to clarify this exception.

Explanation of provision

The bill clarifies section 704(d) by providing that, for a partnership to qualify under the real property exception to the limitation on the allowance of partnership losses in the case of nonrecourse loans, substantially all of the activities of the partnership must relate to the holding of real property (other than mineral property) for sale or rental. The amendment also makes it clear that active as well as passive rental operations are within the real property exception to the new loss limitation of section 704(d).

Effective date

This provision is applicable to liabilities incurred after December 31, 1976.

Revenue effect

This provision has no effect on budget receipts.

20. Exempt-Interest Dividend of Regulated Investment Companies (sec. 2(t) of the bill and sec. 851 of the Code)

Present law

A regulated investment company (commonly called a mutual fund) is permitted a deduction for dividends paid to its shareholders if it meets several tests. One of the tests is that at least 90 percent of its gross income must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities. Another of the tests is that less than 30 percent of its gross income must be derived from the sale or other disposition of stock or securities held for less than 3 months.

The 1976 Act contained an amendment to the provisions dealing with regulated investment companies which permits a company to pay exempt-interest dividends to its shareholders if at least 50 percent of its assets are invested in tax-exempt State and local governmental obligations. However, interest on tax-exempt State and local governmental obligations is not included in gross income. Consequently, a regulated investment company investing all or most of its assets in tax-exempt obligations could fail to meet the 90- and 30-percent tests if, for example, it recognizes a relatively small amount of nonqualifying income.

Also, a shareholder may invest in an open end tax-exempt mutual fund shortly before the record date of a future dividend and then tender his share for redemption immediately after the receipt of the

tax-exempt interest dividend. Since the fund's assets have been depleted by the amount of the dividend, the shareholder will generally recognize a short-term capital loss on the redemption in the amount of the dividend. The net effect of the two transactions is to create an artificial short-term capital loss which can be used to shelter other capital gains of the shareholder.

Reasons for change

The committee believes that the tests for determining whether a corporation qualifies as a regulated investment company should be made by including tax-exempt interest in gross income. In addition, the committee believes that it should not be possible to create an artificial loss through the purchase and sale of shares in a regulated investment company that pays exempt-interest dividends.

Explanation of provision

The bill, as passed by the House and reported by the committee provides that "gross income" for purposes of the 90- and 30-percent tests includes tax-exempt interest. In addition, the bill disallows any loss recognized within 31 days of the date of purchase on shares in a tax-exempt mutual fund to the extent of any exempt interest dividend received by the shareholder.

Effective date

The amendments made by this section are effective for taxable years beginning after December 31, 1975.

Revenue effect

This provision has no effect on budget receipts.

21. Real Estate Investment Trusts (sec. 2(u) of the bill and secs. 860, 856, 6501 and 859 of the Code)

Present law

Real estate investment trusts (REITs) are treated under the tax law in a manner similar to mutual funds, so that if a qualifying REIT distributes at least 90 percent of its income to the shareholders, the income is taxed to the shareholders and not to the REIT. There are several income source tests which must be satisfied in order to qualify as a REIT, among which is the requirement that at least 75 percent of the trust's gross income must come from rents, interest on mortgages and other sources related to the holding of real estate for investment.

The 1976 Tax Reform Act made extensive changes to the provisions relating to taxation of REITs and their shareholders. Under prior law, for example, a REIT could elect a fiscal year, and, if its shareholders used the calendar year for tax purposes, the shareholders could obtain a delay of up to two years in reporting income flowed through from the REIT. The 1976 Act provided that a REIT could not in the future adopt or change to any annual accounting period other than the calendar year.

Prior law also prohibited a REIT from holding property, other than property qualifying as foreclosure property, for sale to customers in the ordinary course of business. The 1976 Act permits REITs to hold such property; however, the net income from the sale of the prop-

erty is taxed at a rate of 100 percent. In addition, gains derived from such property generally do not qualify for purposes of meeting the income source tests.

Reasons for change

The committee noted that the provisions in the 1976 Act requiring a taxable year did not specifically require a newly electing REIT to adopt a calendar year if it had previously adopted a fiscal year for tax purposes. It was also noted that, under the amendments made by the 1976 Act, it was possible for gain derived from shares in another REIT to qualify for the 75-percent income source test even though these shares were held primarily for sale.

Explanation of provision

The bill, as passed by the House and reported by the committee, amends the REIT taxable year provisions to require that any corporation, trust, or association which first qualifies for REIT status after October 4, 1976, must adopt or change to a calendar year in order to be eligible for REIT status. In addition, the bill clarifies the income source rules to require that, for purposes of the 75-percent income source test, qualifying income does not include gain from the sale of REIT shares which were held primarily for sale. The bill also corrects several erroneous or omitted cross references which relate to the REIT amendments in the 1976 Act.

Effective date

These provisions are effective as of October 4, 1976 (the effective date of the 1976 Tax Reform Act).

Revenue effect

This provision has no effect on budget receipts.

22. Amendments Relative to the Treatment of Foreign Income (sec. 2(v) of the bill)

a. Taxation of possessions corporations (secs. 2(v) (1) and (11) of the bill and secs. 901(g)(1) and 936 of the Code)

Present law

The 1976 Act restructures the taxation of U.S. corporations substantially all of whose operations are in Puerto Rico and the possessions ("possessions corporations"). In brief, the Act provides that possessions corporations are entitled to a tax credit equal to the U.S. tax which otherwise would be paid on the income derived from the active conduct of a trade or business in a possession or from investments in the possession of the earnings from a possessions business.

A recent Tax Court case (*Kewanee Oil Co.*, 62 T.C. 728) has held that the sale of substantially all the assets of a trade or business does not, for purposes of the Western Hemisphere trade corporation provisions, constitute income derived from the active conduct of a trade or business. The 1976 Act does not specify the treatment of this type of sale for purposes of the possessions tax credit.

In addition to the tax credit for income earned by possessions corporations, the 1976 Act provides that corporate shareholders are entitled to the dividend-received deduction with respect to dividends from possessions corporations. As a result, Congress decided that it was inappropriate to allow a foreign tax credit for taxes imposed on distributions from possessions corporations to U.S. shareholders which are also partially or fully exempt from U.S. tax because of the dividends-received deduction or other nonrecognition provisions. However, the Act (sec. 901(g)) disallows the credit even where the distribution was fully subject to U.S. tax. For example, the credit is denied with respect to withholding taxes on dividends from possessions corporations which are received by individuals although individuals are not entitled to the dividends-received deduction.

Reasons for change

The recent Tax Court case involving a sale of substantially all of the assets of a Western Hemisphere trade corporation can result in an implication that in a similar situation a sale of assets by a possessions corporation will not qualify for the possessions tax credit. This implication was not intended under the 1976 Act and is corrected by this bill.

In addition, the 1976 Act provision disallowing any foreign tax credit on dividends from possessions corporations was intended to apply only where those dividends are exempt (or substantially exempt) from U.S. tax. The committee believes it is necessary to make conforming changes to carry out this intention.

Explanation of provision

The bill makes it clear that taxable income from the sale of substantially all the assets which had been used by a possessions corporation in the active conduct of a possession business may qualify for the possessions tax credit. In addition, the bill provides that income from the sale or exchange by a possessions corporation of any asset generally will not qualify for the credit if the basis of the asset (for purposes of determining the gain on the sale or exchange) is determined in whole or in part by reference to its basis in the hands of another person. Gain on the sale of an asset with a carryover basis will qualify, however, if the person (or persons) whose basis in the asset has been carried over was, for the entire period that the person held the stock, a possessions corporation (under sec. 931 or 936) or a corporation organized in Puerto Rico or a possession and described in section 957(c).

The bill also provides that the denial of the foreign tax credit with respect to taxes imposed on distributions from possessions corporation does not apply where the distribution is fully taxable by the U.S. Where the recipient of the distribution (including an indirect recipient such as a corporate partner of a partnership or corporate beneficiary of a trust which directly receives the dividend) is entitled to a dividends-received deduction attributable to the distribution, the credit is denied with respect to the full amount of the taxes imposed on the distribution. Where the distribution is received in connection with a liquidation or other transaction, the credit is denied to the extent that the taxes are imposed on income, gain or loss which is not recognized for U.S. tax purposes by the recipient. The bill also makes it clear that the disallowance of the credit also applies in the case of distribution from corporations described in section 957(c) in situations where income, gain, or loss is not recognized.

Effective date

The provision generally applies to taxable years beginning after December 31, 1975. The provision disallowing foreign tax credits in the case of distributions from section 957(c) Corporations applies to distributions made after the date of enactment.

Revenue effect

This provision will reduce budget receipts by less than $10 million in fiscal year 1978, and by less than $5 million annually thereafter.

b. Foreign tax credit adjustments for capital gains (secs. 2(v)(2) (A) and (B) and sec. (3) of the bill and sec. 904 of the Code)

Present law

The 1976 Act made several adjustments to the computation of the foreign tax credit to take account of the fact that capital gains are taxed differently from ordinary income. Code section 904(b) (2), added by section 1031 of the Act, establishes the rules for determining the manner in which income and loss from the sale of capital assets is taken into account in computing the credit. However, the provision applies those adjustments only for the computation of the limitation itself and not for other purposes.

Reasons for change

The Act leaves unclear whether the adjustments required for capital gains income apply before or after other adjustments required (under sec. 904) in order to compute a taxpayer's foreign tax credit limitation. For example, it is not clear in the statute whether the loss recapture rules (of sec. 904(f)) apply before or after any capital gains adjustments. In addition, the reduction provided for in the 1976 Act in the amount of foreign capital losses taken into account in computing the numerator of the foreign tax credit limiting fraction does not apply to capital loss carryovers and carrybacks.

Explanation of provision

The bill provides that the adjustments with respect to capital gains and losses apply for all foreign tax credit limitation purposes (i.e., sec. 904) so that the adjustments are applicable for loss recapture purposes. In addition, the bill amends clause (iii) of section 904(b)(2)(A) to make it clear that the three-eighths reduction provided with respect to foreign capital losses which offset U.S. source net capital gains is to be made only in computing the numerator of the limiting fraction and to provide that the adjustment is also made where the foreign capital loss is a capital loss carried forward from a preceding year or carried back from a succeeding taxable year.

Effective date

The provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision has no effect on budget receipts.

c. ***Treatment of capital loss carryovers and carrybacks for recapture purposes (sec. 2(v)(4) of the bill and sec. 904 of the Code)***

Present law

The 1976 Act provides that where a taxpayer has an overall foreign loss (or a foreign oil related loss) in one year, that loss is to be recaptured by recharacterizing foreign source income (or foreign oil related income) earned in future years as U.S. source income for foreign tax credit limitation purposes. An overall foreign loss is the amount by which foreign source income is exceeded by the deductions attributable thereto; a foreign oil related loss is the amount by which foreign oil related income is exceeded by deductions attributable thereto. Since foreign net operating losses carried to other years are included in the computation of the overall foreign loss or foreign oil related loss in the year sustained for recapture purposes, net operating loss carryovers or carrybacks are excluded from the computation of any overall foreign losss or foreign oil related loss for the year in which deducted in order to prevent a double counting of the loss. The Act similarly excludes capital loss carrybacks and carryovers from overall foreign loss and foreign oil related loss.

Reasons for change

Since capital losses are deductible only to the extent of capital gains (plus a limited amount allowed to offset ordinary income of individuals under sec. 1211(b)), foreign capital losses which are not de-

ductible in the year incurred are not included in overall foreign loss or foreign oil related loss in either the year sustained or the year to which carried; thus, they are not subject to recapture. This exclusion of capital loss carryovers from the loss recapture provisions was not intended.

Explanation of provision

The bill amends the definition of overall foreign loss and foreign oil related loss to eliminate the exception for capital loss carryovers and carrybacks. Thus, such losses will be subject to recapture to the extent they are used as carryovers or carrybacks in years in which the taxpayer has an overall foreign loss or a foreign oil related loss.

Effective date

The provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will increase budget receipts by less than $1 million per year.

d. Effective date of recapture of foreign oil related losses (sec. 2(v)(5) of the bill and sec. 904 of the Code)

Present law

The provisions requiring recapture of foreign oil related losses were added to the Code by the Tax Reduction Act of 1975. The provisions applied to losses sustained in taxable years ending after December 31, 1975. The 1976 Act modified the rules relating to recapture of foreign oil related losses and extended recapture to all foreign losses. The modifications to the foreign oil related loss recapture rules were intended to apply retroactively to the effective date of those rules under the Tax Reduction Act. However, the effective date of the 1976 Act modifications is taxable years *beginning* after December 31, 1975, rather than taxable years *ending* after December 31, 1975 (the effective date of the oil related loss recapture rules under the Tax Reduction Act).

Explanation of provision

The bill corrects this technical defect by providing that the modifications dealing with recapture of foreign oil related income made the 1976 Act apply to taxable years ending after December 31, 1975.

Effective date

This provision is effective upon enactment.

Revenue effect

The provision has no effect on budget receipts.

e. Transitional rule for recapture of foreign losses (sec. 2(v)(7)(A) of the bill and sec. 904(f) of the Code)

Present law

Prior to the Tax Reform Act of 1976, foreign losses generally reduced U.S. tax on U.S. source income by decreasing the worldwide taxable income on which the U.S. tax was based. In addition, when the business operations in the loss country (or countries) became

profitable, a credit against U.S. tax was allowed for taxes paid to that country (or countries) without any recapture of the prior benefits from foreign losses (except in the case of foreign oil related losses, which were subject to recapture).

To reduce these advantages, the 1976 Act extended the recapture provisions to all foreign losses. The Act requires that, in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the loss is to be recaptured by the United States if the company subsequently derives income from abroad. In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources.

The loss recapture provisions apply to losses sustained in taxable years beginning after December 31, 1975. An exception to the effective date is provided for cases where a loss sustained in 1976 is from an investment in a corporation which became substantially worthless prior to the effective date. This exception applies where a corporation has suffered an operating loss in three out of the five years preceding the year in which the loss was sustained, the corporation has sustained an overall loss for those five years, and the termination takes place before January 1, 1977.

An additional exception was provided for cases where an investment is continued beyond 1976 in an attempt to try to make the investment profitable, although the attempt may ultimately fail. The Act provides that if a loss would qualify for the above exception to recapture but for the fact that the investment was not terminated in 1976, and 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.

Reasons for change

A problem has arisen under the exception relating to deficits in earnings and profits prior to 1976 in that the Act requires that the deficit be computed with respect to all years of the corporation. However, in the case of a taxpayer who purchased a previously existing foreign corporation, the earnings and profits record for the years prior to the acquisition may not be available. Moreover, any losses (or profits) of the corporation prior to its acquisition by the U.S. taxpayer are not necessarily relevant to the taxpayer's loss upon later sale of that corporation, since the price paid by the U.S. taxpayer presumably reflects the accumulated earnings and profits (or any deficit) prior to the date of acquisition.

In addition, problems can arise for U.S. taxpayers owning foreign corporations prior to 1962 because, unless dividends are likely to be paid out of pre-1962 earnings, the corporation may not have retained earnings and profits records from pre-1962 years.

Explanation of provision

The bill modifies the exception to the recapture rules for substantially worthless investments disposed of after 1976 and before 1979. Under the bill, in computing the December 31, 1975, deficit in earnings and profits, there is only to be taken into account earnings or deficits of years after 1962 and then only to the extent that the taxpayer held the stock of the substantially worthless corporation in those years. This period would include any tacked-on holding period under section 1223).

Effective date

The provision applies to taxable years after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $5 million over the next several years.

f. Transitional rule for recapture of possessions source losses (sec. 2(v)(7)(B) of the bill and sec. 1032 of the Act)

Present law

Prior to the Tax Reform Act of 1976, foreign losses of a taxpayer electing the per country limitation on the foreign tax credit could be used to reduce U.S. tax on U.S. income in the year of the loss. In subsequent years when income is earned in that foreign country, little or no U.S. tax was obtained because of foreign taxes allowed as credits against that income.

The 1976 Act repealed the per country limitation for years beginning with 1976 and, in addition, provided that any foreign losses on an overall basis are to be recaptured out of future foreign income.

However, the Act provided a three-year exception (i.e., up to 1979) to the repeal of the per country limitation for income from sources within a possession of the United States (including Puerto Rico). No similar exception was provided for the loss recapture rule, but any losses reducing U.S. tax under the per country limitation during the 3-year period are only to be recaptured on a per country basis.

Reasons for change

In the conference relating to the Tax Reform Act of 1976, the conferees had agreed to adopt an exception to the loss recapture rules for losses arising in the possessions through 1978. However, the provision was inadvertently omitted from the conference report and the final legislation as enacted.

Explanation of provision

The provision creates an exception to the loss recapture rule for possession source income for taxpayers using the per-country limitation. Under the exception, losses from the possessions arising in years before 1979 generally would not be subject to recapture where those losses are attributable to a trade or business which was conducted in the possessions before 1976. However, losses from possessions sources incurred during the pre-1979 transition period would nevertheless be subject to recapture in years after 1978 to the limited extent that affiliates of the taxpayer earn possessions source income during those years which is not included in the consolidated return (for example, income earned by an affiliated corporation making an election under sec. 936). The committee amendment makes it clear that losses which do not qualify for the limited exception to the recapture rules because they are not attributable to a trade or business engaged in by the taxpayer in the possession ince 1975 are subject to recapture on a per-country basis only if (1) they credited rather than deducted foreign taxes in the year the loss arose, and (2) the transitional per-country limitation for possessions applied to that year.

Effective date

The provision is effective upon enactment.

Revenue effect

This provision will reduce budget receipts by approximately $2 million in fiscal year 1978. It is not likely to have any additional revenue effect until 19980, after which time there is some possibility that it could decrease budget receipts by up to $10 million.

g. Transitional per-country rules for certain mining companies (sec. (2)(v)(6) of the bill and sec. 904 of the Code)

Present law

Under the 1976 Act, the per-country limitation could to be used by certain mining companies with respect to foreign mining income for a 3-year transitional period (taxable years beginning before January 1, 1979). The transitional rule provides also that any losses sustained by the mining companies would be recaptured on a per-country basis against income subsequently earned in the country where the loss was sustained. However, the transitional rule as drafted would require losses sustained by all qualifying mining companies during the 3-year transition period to be recaptured on a per-country basis even in those cases where, with respect to the year of the loss, the taxpayer elects to use the overall limitation rather than the transitional per-country limitation.

The bill amends the per-country transitional rule so that foreign mining losses sustained during the transition period will be recaptured on a per-country basis only if the transitional per-country limitation applied to the year in which the loss is sustained.

Reasons for change

The transition rule applying per-country recapture for mining companies was intended to apply only where the company is in fact on the per-country limitation for foreign tax credit purposes.

Explanation of provision

The bill amends the per-country transitional rule so that foreign mining losses sustained during the transition period will be recaptured on a per-country basis only if the transitional per-country limitation applied to the year in which the loss is sustained.

Effective date

This provision will increase budget receipts by less than $1 million

Revenue effect

This provision will increase budget reecipts by less than $1 million per year.

h. Limitation on credits for foreign taxes on oil and gas extraction income earned by individuals (sec. 2(v)(8) of the bill and sec. 907 of the Code)

Present law

The 1976 Act made several modifications with respect to the limitations on credits for foreign taxes paid on oil and gas extraction income. In the case of corporations, the limitation on extraction taxes was reduced to 48 percent, the maximum tax which the U.S. would

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impose on such income. However, in the case of noncorporate taxpayers, it was felt that the 48-percent limitation was not appropriate because foreign extraction taxes should be allowed as creditable taxes to the extent of the effective U.S. tax rate on the extraction income and noncorporate taxpayers could be subject to U.S. tax on that income at average rates in excess of the corporate rates.

The change in the extraction limit in the case of noncorporate taxpayers was accomplished by eliminating the separate limitations for oil related income and the fixed percentage limitation on the extraction taxes of noncorporate taxpayers and by substituting a separate foreign tax credit limitation for foreign oil and gas extraction income. Thus, the limitation on extraction taxes paid by noncorporate taxpayers is an amount equal to the taxpayer's effective U.S. rate of tax (before foreign tax credit) times the taxpayer's foreign extraction income.

Reasons for change

Although this change effectively accomplishes the intended goal of allowing credits for extraction taxes paid by noncorporate taxpayers up to the amount of the pre-credit U.S. tax on the extraction income, it also has certain unintended additional effects. First, the change operates to allow noncorporate taxpayers full carrybacks and carryovers of all excess extraction taxes, rather than limiting the excess credits which can be carried from a year to 2 percent of extraction income (as in the case of corporations). In addition, it allows noncorporate taxpayers to use extraction losses arising in a country to reduce foreign income which is not oil extraction and then to reduce U.S. source income, rather than requiring that such losses first reduce foreign oil extraction income earned in other countries.

Explanation of provision

The bill retains as the limit on credits for extraction taxes paid by noncorporate taxpayers their pre-credit U.S. tax on extraction income, but it also conforms the treatment of extraction taxes for noncorporate taxpayers to the treatment afforded corporate taxpayers by imposing the separate limitation for foreign oil related income and limiting the excess credits which can be carried from a year to 2 percent of extraction income.

Effective date

The provision applies to taxable years ending after December 31, 1974.

Revenue effect

This provision will increase budget receipts by less than $5 million per year.

i. Foreign taxes attributable to section 911 exclusion (sec. 2(v)(10) of the bill and sec. 911 of the Code)

Present law

The 1976 Act made several modifications to the section 911 exclusion for earned income of U.S. citizens working abroad. (The Tax Reduction and Simplification Act of 1977 deferred the effective date of these provisions until taxable years beginning in 1977.) One of the 1976

Act modifications was to disallow as a credit or deduction those foreign taxes attributable to income which is excluded from U.S. tax. This provision was intended to prevent a double benefit where a taxpayer has a certain amount of his income excluded from tax and in addition is able to use any foreign taxes paid on that income to reduce or eliminate U.S. tax on other income.

Reasons for change

The 1976 Act does not specify how the amount of taxes attributable to excluded income is to be determined in cases where the taxpayer has additional foreign income from the same country in which the excluded income is earned. Consequently, difficulties can arise in coordinating the appropriate disallowance of foreign tax credits with the rules (of sec. 911(d)) determining theU.S. tax treatment of any additional foreign income.

Explanation of provision

The bill specifies the manner in which foreign taxes are to be determined attributable to excluded income and thus disallowed as foreign tax credits. The amount of foreign taxes disallowed is determined by multiplying the amount of the foreign taxes paid by a fraction the numerator of which is the U.S. tax on the excluded amount (plus the applicable zero bracket amount) and the denominator of which is the sum of the numerator plus the foreign tax credit limitation for the year. Under this method, taxes are generally disallowed in the proportion that the tax on the excluded amount bears to the amount of U.S. tax which would be imposed on an amount of taxable income equal to foreign source income (thereby allocating foreign taxes between excluded and nonexcluded foreign source income in proportion to the U.S. progressive tax rate schedule). Where a taxpayer has U.S. source income, the amount of taxes disallowed is somewhat less because the average U.S. effective rate is applied to the nonexcluded foreign source income. However, this method greatly simplifies the calculation because it uses figures that are line items on the return which the taxpayer must compute in any event for other purposes.

Effective date

The provision applies to taxable years beginning after December 31, 1975, the general effective date of the 1976 Act amendments to sec. 911 of the Code. However, since the Tax Reduction and Simplification Act of 1977 deferred the 1976 Act amendments until taxable years beginning in 1977, the provision in this bill will also be effective at that time.

Revenue effect

This provision has no effect on budget receipts.

j. Gain on disposition of stock in a DISC (sec. 2(v)(12) of the bill and sec. 995 of the Code)

Present law

Prior to the 1976 Act, there was no recapture of accumulated DISC income (i.e.. treatment as a dividend) on the distribution of DISC stock in certain tax-free transactions (sec. 311, 336, or 337) because no gain was recognized on the transfer. The accumulated DISC in-

come would also escape recapture upon a subsequent disposition of the DISC stock by the distributee if the distributee did not carry over the distributing corporation's basis and holding period in the DISC stock (but instead received a stepped-up basis). Therefore, the 1976 Act requires recapture of the accumulated DISC income upon a distribution, sale, or exchange of DISC stock to which section 311, 336, or 337 of the Code applies. (Sec. 995(c)(1)(C).)

The amendments by the 1976 Act were effective for sales or other dispositions made after December 31, 1975 in taxable years ending after that date.

Reasons for change

In certain transactions to which sections 311, 336, or 337 apply where the stock of a DISC is transferred from one member to another member of the same controlled group, the distributee does not receive a step-up in basis for the distributed stock, but rather receives a carryover basis. In those instances where the distributee receives a carryover basis, the holding period of the distributing corporation is tacked on to the holding period of the distributee (sec. 1223(2)). Because there is a carryover of basis and holding period in these situations, there is no possibility for the avoidance of the recognition of accumulated DISC income upon the subsequent disposition of such stock by the distributee. Consequently there is no need to recapture the DISC benefits in these instances.

In addition, this recapture provision was not contained in the House version of the 1976 Act but was added to the Act as part of the Senate amendment to the DISC provisions, which generally were effective for sales after December 31, 1976. The conference committee adopted the substantive provisions of the Senate amendment, but with the December 31, 1975, effective date of the House bill. The use of the House bill's December 31, 1975, effective date results in the application of the Senate's recapture rule to transactions occurring during 1976 when the taxpayers did not have notice that the recapture provision would apply.

Explanation of provision

The bill makes the 1976 Act amendment inapplicable to those situations where the distributee of the DISC stock receives both a carryover basis and a tacked on holding period. Thus, for example, in a liquidation of a subsidiary to which section 334(b)(1) applies (in which the basis and the holding period of property distributed by a subsidiary is carried over to its parent), recapture on the distribution of DISC stock would not be required.

The bill also delays the effective date of the DISC recapture provision of the 1976 Act until December 31, 1976.

Effective date

The provision is effective as if it were included in the Tax Reform Act of 1976.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

k. *Limitation on partner's tax where partner is treated as having sold or exchanged section 1248 stock (sec. 2(v)(13) of the bill and sec. 751 of the Code)*

Present law

The 1976 Act provides that if a partnership holds stock in a foreign corporation which would be subject to dividend treatment (under sec. 1248) if sold or exchanged, any gains to a partner receiving certain partnership distributions or selling his interest in the partnership will be treated as ordinary income to the extent that he would have had a dividend had the foreign corporate stock been sold.

Reasons for change

The dividend treatment rules on foreign corporate stock include a specific limitation applicable to individuals (sec. 1248(b)) under which the individual's U.S. tax is limited to (1) his share of any additional tax that would have been payable if the foreign corporation had been a domestic corporation paying tax at the full United States corporate rate plus (2) the capital gains tax which the individual would be liable for on an amount equal to his share of the after-tax earnings and profits (assuming the full U.S. tax rate) of the corporation. The provision in the 1976 Act applying the dividend treatment rules to the partnership area did not include this special limitation relating to individuals. This could have the impact of requiring individuals holding stock in a foreign corporation to pay a substantially greater tax in cases where they sell their interest in the partnership than in cases where they sell the stock directly. The bill corrects this unintended difference.

Explanation of provision

The bill modifies the provision in the Code (sec. 751) which treats certain gains to a partner as an unrealized receivable to the extent the amounts would be treated as gain to which the foreign corporation dividend rules (of sec. 1248) would apply. The modification provides that, in the case of an individual, the tax attributable to the sec. 1248 amount is to be limited in the same manner as it would be limited (under sec. 1248(b)) had the stock in the foreign corporation been sold by the individual or partnership.

Effective date

The provision applies to transfers beginning after October 9, 1975, and to sales, exchanges, and distributions taking place after that date.

Revenue effect

This provision will reduce the budget receipts by less than $1 million per year.

l. *Excise tax on transfers of appreciated assets to foreign entities (sec. 2(v)(14) of the bill and sec. 1491 of the Code)*

Present law

An excise tax (sec. 1491) is imposed upon the transfer of certain appreciated property to foreign entities. The tax applies to citizens or residents of the United States and to domestic corporations, partnerships, and trusts. Under prior law, it did not apply to estates be-

cause the basis of assets transferred at death was "stepped-up" to their fair market value on the date of death (or alternative valuation date where applicable).

The 1976 Act increased the excise tax and expanded the application of the tax to additional types of property. In addition, the Act provided a carryover basis for assets transferred at death. Since assets transferred by estates do not generally receive a step-up in basis, assets transferred by estates to foreign entities can escape both the U.S. capital gains and excise taxes.

The 1976 Act also provides that the excise tax imposed on transfers of property to foreign persons to avoid Federal income tax shall not apply to "a transfer to which section 367 applies". In these instances, the taxation of such transfers are governed by section 367.

Reasons for change

As a result of the 1976 Act changes providing for carryover basis at death, estates can avoid U.S. income tax on transfers of appreciated assets to foreign entities. The bill applies the excise tax on these types of transfers to prevent any tax advantage.

In addition, the exception created in the 1976 Act for transfers to which section 367 applies produces some possibility that specific transfers to which that section does not apply because the IRS has determined that no tax avoidance is involved will inadvertently be subjected to the excise tax.

Explanation of provision

The bill extends the excise tax on transfers of property to foreign entities to transfers made by estates subject to U.S. tax. In addition, it extends the tax to transfers of appreciated property by U.S. persons to foreign estates.

The bill also provides that the excise tax does not apply to "a transfer described in section 367." As a result of this amendment, transfers of property described in section 367, although excepted from its application under section 367(a)(2), will not be subject to the excise tax imposed under section 1491.

Effective date

The provisions apply to transfers made after October 2, 1975.

Revenue effect

This provision will increase budget receipts by less than $1 million per year.

m. Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States (secs. 2(v) (15) and (16) of the bill and sec. 6013(g) and (h) of the Code)

Present law

The 1976 Act permits a nonresident alien individual who is married to a citizen or resident of the United States to file a joint return provided that both spouses elect to be taxed on their worldwide income. Sections 6013 (g) and (h), as added by the Act, both provide that the nonresident alien individual in question "shall be treated as a resident of the United States for purposes of chapter 1 for all of such taxable year."

In addition, the Act provides that the election to be treated as a resident will apply to any individual who, at the time an election was made, was a nonresident alien individual married to a citizen or resident of the United States. A literal reading of this provision results in a timing requirement that, at the time the election is made, one of the spouses must be a nonresident alien married to a U.S. citizen or resident.

Reasons for change

By referring only to chapter 1 of the Code, a nonresident alien qualifying under section 6013 (g) or (h) will be treated as a U.S. resident for joint return purposes, but as a nonresident alien for purposes of the excise tax on transfers of property to a foreign person (chapter 5) and for wage withholding purposes (chapter 24).

An additional problem arises because of the possible interpretation that the nonresident alien electing to file a joint return must be a nonresident at the time the election is made (i.e., at the time the return is filed). This can cause problems where the nonresident becomes a resident of the United States in the period between the year in question and the time for filing the return for that year.

Explanation of provision

The bill, as amended by the committee, provides that nonresident aliens electing under section 6013 (g) or (h) will be treated as U.S. residents for purposes of chapters 5 and 24, as well as chapter 1. It is contemplated that nonresident aliens electing under section 6013 (g) or (h) will be treated as resident aliens under the procedural and administrative provisions of Subtitle F where those provisions relate to the treatment of the taxpayer under chapter 1, 5, or 24. In addition, the bill provides that a refund will be allowed for any overpayment of tax attributable to withholding taxes imposed (under sec. 1441) on income of an electing nonresident alien for a year with respect to which the election applies.

The bill also deletes the requirement that one spouse be a nonresident alien married to a U.S. citizen or resident at the time of the election and provides instead that it applies to nonresident aliens who, at the close of the taxable year with respect to which an election is made, are married to U.S. citizens or residents.

Effective date

The provisions making the election effective for all purposes of chapters 5 and 24 (and related administrative provisions) and clarifying the time with respect to which the individual making the election must be a nonresident alien are effective for taxable years ending on or after December 31, 1975 (the effective date of the 1976 Act provisions). The provision relating to wage withholding (chapter 24 of the Code) are to apply to remuneration paid on or after the first day of the first month which begins more than 90 days after the date of enactment.

Revenue effect

This provision has no effect on budget receipts.

n. Foreign tax credit for production-sharing contracts (sec. 2(v)(9) of the bill and sec. 1035(c) of the Tax Reform Act of 1976)

Present law

An IRS Revenue Ruling (Rev. Rul. 76-215) holds that a contractor operating under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to Indonesia which contractually satisfy the contractor's liability. The IRS announced that this ruling would only apply prospectively to credits claimed for taxes paid in taxable years beginning on or after June 30, 1976.

Apparently the Indonesian taxes affected by the ruling are imposed annually on a calendar year basis, and the entire annual tax liability accrues on December 31 with respect to each year. Consequently, the ruling did not affect the creditability of Indonesian taxes paid and accrued with respect to 1976 by calendar year taxpayers and taxpayers whose fiscal year began before June 30, 1976. With respect to taxpayers whose fiscal year began on or after June 30, the ruling applied to the fiscal year beginning in 1976 and ending in 1977, and therefore disallowed the creditability of Indonesian taxes imposed with respect to 1976.

The 1976 Act provides that Revenue Ruling 76-215 is not to apply to most taxpayers for taxable years ending in 1977 with respect to amounts paid to foreign governments and designated as taxes under production-sharing contracts entered into before April 8, 1976. The 1976 Act generally intended to delay the effect of the ruling for one year so that the companies would have additional time to renegotiate their production-sharing contracts with Indonesia. The Act does result in a one-year delay in the effective date of the ruling for taxpayers on a calendar year basis (for taxes paid with respect to 1977) and for taxpayers with fiscal years beginning on or after June 30 (for Indonesian taxes paid with respect to 1976). In the case of taxpayers with fiscal years beginning before June 30, the Act does not delay the date of the ruling (to cover Indonesian taxes paid with respect to 1977).

Reasons for change

The result of Revenue Ruling 76-215 and the 1976 Act is that calendar year taxpayers are permitted their payments made with respect to 1977 as creditable taxes while fiscal year taxpayers can only credit payments made through 1976. This creates inequities for fiscal year taxpayers.

Explanation of provision

The bill would delay the effect of the revenue ruling until 1978 for all taxpayers (so that amounts paid by all taxpayers in 1977 would be creditable).

Effective date

The provision is effective upon enactment.

Revenue effect

This provision will reduce budget receipts by $5 million in fiscal year 1978 only.

o. *Source of income on liquidation of foreign corporation (sec. 2 (v)(2)(C) of the bill and sec. 904(b) of the Code)*

Present law

Generally, the source of income derived from sale of personal property, including stock, is determined by the place of the sale. However, the 1976 Act provided as a general rule that gain on the sale or exchange of personal property outside the U.S. which is not subject to a foreign tax of at least 10 percent will not be considered foreign source income. That general rule does not apply in certain specified situations including, in the case of a sale by a corporation of stock in a second corporation, those where the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income. The provision was intended to prevent taxpayers from maximizing the use of foreign tax credits by arranging for sales of personal property to take place in low tax foreign countries.

Reasons for change

The 1976 Act provision applies to liquidations as well as to other types of exchanges. However, the potential for artificially arranging a sale in a low-tax country does not exist in the case of liquidations because under the normal source rules any gain from a liquidation has its source in the country of incorporation. Consequently, the need to recharacterize any income resulting from a liquidation as domestic source income is limited to cases where the corporation is incorporated aboard but doing most of its business within the United States.

Explanation of provision

The bill provides that the source of income received by a corporation on the liquidation of a foreign corporation will be treated as foreign source income in all cases except where the foreign corporation derived 50 percent or more of its gross income from U.S. sources for the 3-year period ending with the close of its taxable year immediately preceding the year in which the liquidation occurs.

Effective date

The provision applies to taxable years beginning after December 31, 1975.

Revenue effect

This provision will reduce budget receipts by less than $5 million per year.

23. Gain From Sales Between Related Persons (sec. 2(w) of the bill and sec. 1239(a) of the Code)

Present law

Under present law, gain from sales or exchanges between certain related persons is treated as ordinary income. The 1976 Act expanded the application of this provision (sec. 1239) to include sales or exchanges between commonly-controlled corporations and to determine stock ownership by reference to the attribution rules generally applicable to corporations and shareholders (sec. 318).

In making these changes, the 1976 Act inadvertenly changed the description of the property subject to the provision from "property of the character which is subject to the allowance for depreciation provided in section 167" to property which is "subject to the allowance for depreciation provided in section 167." However, no substantive change was intended by this change in language.

Reasons for change

In order to prevent the possibility of any misinterpretation, the committee believes that it is appropriate to reinstate the language previously used in section 1239, i.e., "property of a character which is subject to the allowance for depreciation provided in section 167."

Explanation of provision

The bill, as passed by the House and reported by the committee, amends section 1239(a) of the Code by deleting the language "subject to the allowance for depreciation provided in section 167," and substituting the language "property of a character which is subject to the allowance for depreciation provided in section 167." No substantive change in the law is intended by this change in language.

Effective date

The amendment made by this section is applicable to sales or exchanges after October 4, 1976 (the date of enactment of the 1976 Act). A sale or exchange is considered to have occurred on or before October 4, 1976 if it is made pursuant to a binding contract entered into on or before that date.

Revenue effect

This provision has no effect on budget receipts.

24. Recapture of Depreciation on Player Contracts (Sec. 2(x) of the Bill and Sec. 1245 of the Code)

Present law

The 1976 Act provided special rules for recapture of depreciation and deductions for losses taken with respect to player contracts. The special recapture rules apply only in the case of the sale, exchange, or other disposition (other than a disposition under which the transferee has a carryover basis) of the entire sports franchise. In the case

of the sale or exchange of individual player contracts, the amount recaptured as ordinary income is determined on a contract-by-contract basis. Under the special recapture rules for sales of the entire franchise, the amount recaptured as ordinary income is the amount of gain not to exceed the greater of (1) the sum of the depreciation taken plus any deductions taken for losses (i.e., abandonment losses) with respect to those player contracts which are initially acquired as a part of the original acquisition of the franchise or (2) the amount of depreciation taken with respect to those player contracts which are owned by the seller at the time of the sale of the sports franchise. Under the provision, the potential recapture amounts for both the initial contracts and the contracts tranferred in connection with the sale of the franchise are reduced by amounts previously recaptured with respect to the applicable contracts.

The special recapture rules provisions apply to transfers of player contracts in connection with any sale or exchange of a franchise after December 31, 1975.

Reasons for change

Since there could be no prior disposition of a contract held at the time the entire franchise is transferred, the reduction for prior recapture amounts for these contracts is unnecessary.

In addition, the special recapture rules for the initial contract recapture pool result in retroactively changing the treatment of depreciation and losses claimed before 1976 if the franchise is sold after December 31, 1975.

Explanation of provision

Under the House bill, and the bill as reported by the committee, the provision for a reduction for prior recapture amounts attributable to contracts actually transferred with the sale or exchange of a sports franchise is deleted.

The bill as reported by the committee also provides that the pool recapture rule for contracts initially acquired with the franchise is to apply with respect to depreciation allowable for periods after December 31, 1975, and losses incurred after December 31, 1975. The House bill did not contain a provision relating to the effective date for the special recapture rules for player contracts.

Effective date

The amendments apply to transfers of player contracts in connection with a sale or exchange of a franchise after December 31, 1975.

Revenue effect

The provision relating to recapture amounts for contracts actually transferred with the sale or exchange of a sports franchise has no effect on budget receipts. The provision relating to the effective date of the special recapture rules will reduce budget receipts by $1 million in fiscal 1978 and by less than $1 million each fiscal year thereafter.

25. Treatment of Pensions and Annuities for Purposes of Maximum Tax on Personal Service Income (sec. 2(y) of the bill and sec. 1348 of the Code)

Present law

The Tax Reform Act of 1976 amended the 50-percent maximum tax on personal service income to provide, in part, that amounts received

as a pension or annuity were treated as personal service income (subject to certain special exceptions). However, the Act did not specifically limit the application of the maximum tax to pensions or annuities which are connected with earning income from personal services.

Reasons for change

Presently, it is unclear if the maximum tax applies to pensions or annuities which do not arise from an employer-employee relationship or from tax deductible contributions to a retirement plan. Congress intended that the maximum tax apply to amounts received as a pension or annuity only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person.

Explanation of provision

The bill, as passed by the House and reported by the committee, clarifies present law by providing that the 50 percent maximum tax applies to a pension or annuity only when the pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person (such as an independent contractor). This clarification applies to pensions and annuities established by an employer for his employee (whether or not made under a qualified pension plan) and to amounts received from H.R. 10 plans and individual retirement accounts, annuities, and bonds. Pensions or annuities that are not connected with earned income from personal services do not qualify. However, this amendment is not intended to deny the benefits of the maximum tax provisions to other deferred compensation arrangements where the compensation is "earned income" within the meaning of section 911(b), i.e., wages, salaries, professional fees, and other amounts received for personal services. For example, payments to a retired partner where the payments are for personal service actually performed prior to retirement are eligible for the 50-percent maximum tax rate (if capital is a material income-producing factor, no more than 30 percent of the payments are eligible).[5]

Effective date

The provision applies to taxable years beginning after December 31, 1976.

Revenue effect

The provision will increase budget receipts by less than $1 million per year.

26. Certain Grantor Trusts Treated as Permitted Shareholders of Subchapter S Corporations (sec. 2(z) of the bill and sec. 1371 of the Code)

Present law

Prior to the 1976 Act, a corporation could not elect to be treated as a subchapter S corporation if it had a trust as a shareholder. However, an estate was permitted to be a shareholder. Under the Tax Re-

[5] These payments would be eligible for the maximum tax rate because they are defined as earned income under section 911(b) although, under section 911(c)(5), no foreign source income exclusion is allowed under section 911(a) for deferred compensation.

form Act, a so-called "grantor trust" is permitted to be a shareholder of a subchapter S corporation. In addition, the 1976 Act permitted a testamentary trust to be a shareholder in a subchapter S corporation for 60 days. However, the 60-day period was not extended to a grantor trust following the grantor's death although, in many cases, the trust is used as a will substitute.

Reasons for change

The committee believes that a grantor trust should be permitted to be a shareholder of a subchapter S corporation for two years after the death of the grantor, since this type of trust is often used as a will substitute and should be treated in a manner similar to an estate.

However, where the corpus of the trust is not includible in the estate, only 60 days should be allowed. In addition, the committee wishes to clarify that the grantor of a grantor trust must himself be an eligible shareholder for the trust to qualify.

Explanation of provision

The provision amends the qualification requirements for subchapter S treatment to permit a grantor trust to be an eligible shareholder for a two-year period following the grantor's death if the entire corpus of the trust is includible in the grantor's gross estate. If the entire corpus is not included in the grantor's gross estate, only 60 days are provided. The two-year period is roughly equivalent to the estate and trust period with respect to testamentary trusts, i.e., a normal period of administration while the stock is held by the estate and a 60-day period after the testamentary trust receives the stock from the estate.

The provision also makes it clear that a grantor trust is an eligible shareholder only if the grantor would be an eligible shareholder, i.e., the grantor is an individual citizen or resident of the United States.

The provision is the same as in the House bill.

Effective date

This provision is effective for taxable years beginning after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

27. Withholding of Federal Taxes on Certain Individuals Engaged in Fishing (sec. 2(aa) of the bill and secs. 1402(c), 3121(b)(20), and 3401(a) of the Code)

Present law

The Tax Reform Act of 1976 changed the prior law treatment of certain individuals engaged in fishing for payroll tax purposes. Prior to the 1976 Act, the Internal Revenue Service frequently treated members of a fishing boat crew as employees rather than as self-employed individuals. As a result, operators of the boats had to withhold taxes from the wages of crew members, and also had to deduct and pay Social Security taxes.

Under the 1976 Act, members of a fishing boat crew are to be treated as self-employed persons for Federal Withholding and Social Security tax purposes if their sole remuneration is a share of the boat's catch

(or a share of the proceeds of the catch) or, in the case of an operation involving more than one boat, a share of the entire fleet's catch or its proceeds. For this rule to apply, the boats must have operating crews of less than 10 members.

Generally, the changes made by the 1976 Act are applicable to services performed after December 31, 1971.

Reasons for change

It has been brought to the committee's attention that the provision enacted under the 1976 Act does not cover all open cases because of the effective date.

Explanation of provision

The bill would extend the treatment provided for crew members in the 1976 Act to all services performed after December 31, 1954.

Effective date

The provision is to apply to services performed after December 31, 1954.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

28. Tax on Excess Individual Retirement Plan Contributions (sec. 2(bb) of the bill and sec. 4973(a) of the Code)

Present law

Under present law, deductible contributions by an individual for a taxable year to an Individual Retirement Account (IRA) are generally limited to the lesser of $1,500 or 15 percent of earned income. The 1976 Act increased the dollar limitation to $1,750 where contributions to the account are allocated equally between a spouse with earned income and a spouse with no earned income. If an amount in excess of the deductible amount is contributed, the owner of the IRA is subject to a 6-percent nondeductible excise tax on the excess for the year of contribution and each later year for which the excess remains in the account.[6] The 1976 Act also amended the excise tax provisions to provide that the tax on excess contributions would be imposed on the spouse to whom an IRA deduction is allowed (sec. 1501(b)(8)(A) of the Act and sec. 4973(a) of the Code). However, the deadwood provisions of the 1976 Act (sec. 1904(a)(22)) had the effect of repealing that amendment.

Reasons for change

The committee believes that it is necessary to make an appropriate correcting change.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides for the imposition of the exise tax on the spouse who is allowed the deduction with respect to the contributions made to such account.

[6] If the contribution exceeds the 15-percent limit but not the applicable maximum dollar ceiling, the excise tax can be avoided if the excess is withdrawn before the end of the taxable year in which it was contributed.

Effective date

This provision applies for taxable years beginning after December 31, 1976, the date the provision of the 1976 Act was intended to apply.

Revenue effect

The provision has no effect on budget tax receipts.

29. Disclosure of Returns and Return Information (sec. 2(cc) of the bill and secs. 6103, 7213 and 7217 of the Code)

Present law

The 1976 Act significantly increased the confidentiality of returns and return information by restricting the instances in which returns or return information may be disclosed to those agencies and individuals enumerated in section 6103 of the Code.

The 1976 Act treats taxpayer return information, including the address supplied by the taxpayer on his or her tax return, as confidential information not subject to disclosure by the IRS, except as specified in the Act. While the Act provides for disclosure of address information in certain situations, no provision was made in the Act to permit the disclosure of the mailing address of persons who have defaulted on student loans made under part E of title 4 of the Higher Education Act of 1965.

Under the 1976 Act, the Justice Department and other Federal agencies are required in nontax criminal cases to obtain court approval in order to receive return information which was filed by or on behalf of a taxpayer with the IRS. The court approval procedure, however, does not apply to return information which is not furnished by or on behalf of the taxpayer. Thus, in nontax criminal cases, the IRS may disclose to the Justice Department or other Federal agency return information, other than that furnished by or on behalf of the taxpayer, including return information which may constitute evidence of a violation of the Federal criminal laws (secs. 6103 (i)(2) and (i)(3)). In order for the IRS to transmit this information to the Justice Department or other Federal agency, it is necessary, of course, to provide the name and address of the taxpayer. Because the taxpayer furnishes his name and address on his return, it is arguable that the IRS would not be able to provide this information to the Justice Department or other Federal agency, thus completely negating the purpose and operation of these provisions.

The 1976 Act provided that returns and return information relating to specified Federal taxes could generally be disclosed to State tax officials for the purpose of, but only to the extent necessary in, the administration of State tax laws. However, the 1976 Act omitted taxes imposed by chapter 31 of the Code (i.e., the special fuel excise taxes) from the list of taxes with respect to which information could be disclosed to State tax officials. As a result, the IRS no longer has the authority to provide State tax officials with returns or return information regarding special fuel excise taxes.

The 1976 Act provides that returns or return information may be disclosed to a competent authority of a foreign government which has an income tax treaty with the United States, but only to the extent provided in and subject to the terms and conditions of such treaty.

Under the 1976 Act, the criminal violation of the disclosure rules is a felony punishable by a fine of up to $5,000, or imprisonment of up to 5 years, or both. It is also a felony, subject to the same penalties, for any person to receive an unauthorized disclosure of returns or return information as a result of an offer by that person to exchange an item of material value for the unauthorized disclosure. The 1976 Act also provides that any person who knowingly or negligently discloses returns or return information in violation of the law is liable to the taxpayer for actual damages sustained plus court costs (but in no event less than $1,000 liquidated damages with respect to each unauthorized disclosure).

Reasons for change

The committee believes that it is important to permit the disclosure of address information to the Commissioner of Education and educational institutions, for the purpose of locating individuals who have defaulted in payment of student loans.

The bill corrects the inadvertent omission of fuel excise tax returns from the list of returns that may be disclosed to State tax authorities. The bill also corrects a technical problem in the provision providing the IRS with the authority to make disclosures to the Justice Department and other Federal agencies of information not furnished by the taxpayer, where the information involved constitutes evidence of a violation of the Federal criminal laws.

Finally, because of the possible criminal or civil liability which Government employees handling returns and return information might face in the event of an unauthorized disclosure, the committee decided that certain clarifying changes should be made to the civil and criminal penalty provisions in order to eilminate any possible doubt as to their meaning.

Explanation of provisions

Disclosure of mailing addresses to the Commissioner of Education and educational institutions (sec. 2(cc)(1) of the bill and sec. 6103(m)(4) of the Code)

Upon the receipt of a written request, the Secretary will be authorized to disclose to the Commissioner of Education the mailing address of any taxpayer who has defaulted on a loan made from a student loan fund established under part E of title IV of the Higher Education Act of 1965 for use only to locate the taxpayer for purposes of collecting the loan. Any mailing address received by the Commissioner of Education under this provision may, in turn, be disclosed by the Commissioner of Education to any educational institution with which he has an agreement under part E of title IV of the Higher Education Act of 1965. These addresses will only be disclosed to employees and agents of the educational institution whose duties relate to the collection of student loans and only for the purposes of locating and collecting the loans from the individuals who have defaulted on student loans made by the institution pursuant to this agreement.

Disclosure to State tax authorities of returns and return information regarding special fuel excise taxes (sec. 2(cc)(2) of the bill and sec. 6103(d) of the Code)

This amendment includes returns and return information regarding the special fuel excise taxes imposed under chapter 31 of the Code

among the returns and return information which the IRS is authorized to disclose to State tax officials.

Disclosure of name and mailing address to the Justice Department and other Federal agencies (secs. 2(cc) (3) and (4) of the bill and secs. 6103(i) (2) and (3) of the Code)

These amendments permit the IRS to transmit to the Justice Department and other Federal agencies the name and address of a taxpayer along with return information (including return information indicating the violation of a Federal criminal law) pertaining to, but not furnihed by or on behalf of, the taxpayer.

Disclosure under tax conventions (sec. 2(aa) (5) and sec. 6103(k) (4) of the Code)

The bill, as amended by the committee, authorizes the Secretary to disclose returns or return information to a competent authority of a foreign government which has an estate and gift tax convention with the United States or other convention relating to the exchange of tax information, but only to the extent provided in and subject to the terms and conditions of such convention.

Criminal penalty for unauthorized disclosure of returns and return information (secs. 2(cc) (1) and (6) of the bill and sec. 7213 of the Code)

The Code provision imposing criminal penalties for unauthorized disclosures, printings, publications, and solicitations (sec. 7213) is amended in two respects. First, any employee or agent of an educational institution receiving a taxpayer's address in regard to a defaulted student loan, who, in turn, makes a disclosure which is not authorized under section 6103, will be subject to the criminal penalties of section 7213.

Second, the section is clarified by explicitly providing that the criminal penalties of section 7213 are to apply only to willfully made disclosures, printings, publications, or solicitations, as the case may be. The term "willfully" relates to a voluntary, intentional violation of a known legal duty. See, *U.S.* v. *Pomponio*, 97 S. Ct. 22 (1976).

Civil penalties for unauthorized disclosures (sec. 2(cc) (7) of the bill and sec. 7217 of the Code)

The code provision imposing civil penalties for knowing or negligent unauthorized disclosures of returns and return information (sec. 7217) is amended to provide that no liability for this penalty shall arise in the event of an unauthorized disclosure which results from a good faith, but erroneous, interpretation of section 6103 and the rules and regulations relating thereto.

Effective date

Except for the amendment under section 2(aa) (7), the amendments made by this provision are effective on January 1, 1977. The amendment under section 2(aa) (7) (relating to relief from civil penalty liability in certain circumstances) is to apply to disclosures made after the date of enactment of this Act.

Revenue effect

This provision has no effect on budget receipts.

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30. Definition of Income Tax Return Preparer and Negotiation of Taxpayer Refund Check by Banks (sec. 2(dd) of the bill and secs. 6695 and 7701 of the Code)

Present law

The Tax Reform Act of 1976 expressly exempts a fiduciary of a trust or an estate from certain rules relating to income tax return preparers for returns or claims for refund prepared for that trust or estate. However, other persons who prepare returns in a fiduciary capacity are not specifically excepted from the rules (for example, certain conservators or guardians whose fiduciary responsibilities are similar to those of trustees or executors).

The 1976 Act also prohibited any tax return preparer from endorsing a refund check of any taxpayer whose return he prepared (except for subsequent endorsements by banks). A $500 fine was provided for violation of this provision.

Reasons for change

Many persons prepare returns of taxpayers in their capacity as a guardian, conservator, or other fiduciary with respect to the taxpayer. Under the 1976 Act in this case, the person was considered a tax return preparer. However, it is not necessary for the tax return preparer provisions to apply because these persons and their employees are generally subject to the considerably higher standards imposed on fiduciaries under local law.

All of the requirements of the 1976 Act also apply to banks which are tax return preparers for their customers generally (i.e., in other than a fiduciary capacity). In this case, although the bank should be subject to the basic rules relating to income tax preparers, there is no need to apply the prohibition against check endorsements where the check is deposited by the bank to the taxpayer's own account.

Explanation of provision

The bill creates an exception from the definition of tax return preparer for any person who prepares as a fiduciary a return or claim for refund for another person. The exception is limited to those returns of taxpayers with respect to whom the preparer is a fiduciary and does not affect a tax return preparer's status with respect to returns of other taxpayers.

In addition, the bill permits banks (as defined in sec. 581 of the Code) to endorse and deposit a customer's tax refund check in full to the customer's account in any case where the customer's tax return was prepared by that bank without violation of the penalties relating to endorsements of taxpayers' refund checks by tax return preparers.

Effective date

The provisions apply to documents prepared after December 31, 1976, and to taxpayer refund checks issued with respect to returns prepared after December 31, 1976.

Revenue effect

This provision has no effect on budget receipts.

31. Negligence Penalty for Income Tax Preparers (sec. 2(dd) of the bill and sec. 6694 of the Code)

Present law

The Tax Reform Act of 1976 established a penalty of $100 per return for income tax return preparers who prepare a return containing an understatement of tax liability due to the "negligent or intentional disregard of rules and regulations." The courts have held that a revenue ruling does not have the status of Treasury regulations or provisions of the Internal Revenue Code and is not necessarily binding on the Secretary of the Treasury, the taxpayer, or the courts.[7]

The Internal Revenue Service issued final regulations under the 1976 Act provisions stating that the term "rules and regulations" includes IRS revenue rulings. Thus, under the final regulations, disregard of an IRS revenue ruling in certain situations (i.e., situations other than where the preparer in good faith and with reasonable basis takes the position that the ruling does not properly interpret the Code) may lead to a negligence penalty.

Reasons for change

The committee believes that the disregard of an Internal Revenue Service revenue ruling should not constitute a negligent or intentional disregard of rules or regulations for purposes of the negligence penalty.

Explanation of provision

The bill, as amended by the committee, provides that the disregard of an Internal Revenue Service revenue ruling, or written determination (within the meaning of section 6110(b)(1), which has precedential status), does not constitute a negligent or intentional disregard of rules or regulations for purposes of the negligence penalty, unless the ruling or written determination pertains to the person with respect to whom a return or claim was prepared.

There is no comparable provision in the House bill.

Effective date

This provision applies to documents prepared after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

32. Declaratory Judgments—Revocation of Prior Determination (sec. 2(ee) of the bill and secs. 7428 and 7476 of the Code)

Present law

In the 1974 pension Act (ERISA), Congress provided for declaratory judgments "in a case of actual controversy involving—(1) a determination by the Secretary with respect to the initial qualification *or continuing qualification* of a retirement plan * * *." (Emphasis supplied.)

The 1976 Act provided for declaratory judgments "in a case of an actual controversy involving—(1) a determination by the Secretary—(A) with respect to the initial qualification *or continuing qualification of* an organization as an organization described in sec-

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[7] *Stubbs, Overbeck and Associates, Inc.*, v. *U.S.* 445 F. 2d. 1142 (5th Cir. 1971).

tion 501(c)(3) * * *." (Emphasis supplied.) Both the House and Senate committee reports on the 1976 Act stated that this statutory language, in both Acts, is intended to grant jurisdiction in cases where the Internal Revenue Service has concluded that a previously qualified organization has lost its preferred tax status.

On October 6, 1976, the Tax Court published an opinion (*Sheppard & Myers, Inc.* v. *Comm'r*, 67 T.C. 26) in which it held that the retirement plans declaratory judgment provisions do not apply to revocations of favorable determination letters. The Tax Court decision made no mention of the 1976 Act or of the committee reports on that Act.

Reasons for change

The legislative history of ERISA and of the Tax Reform Act of 1976 clearly indicate that Congress intended the Tax Court to have jurisdiction over cases involving revocation of prior favorable determination by the IRS. However, in light of the recent *Sheppard & Myers Inc.* case, it appears that this intent should be expressed explicitly in the statute.

Explanation of provisions

The bill makes clear that the declaratory judgment provisions relating to the qualification of retirement plans and relating to the status and classification of charitable organizations are to apply for revocations of any IRS determination in these areas.

Effective date

Under the bill, as passed by the House and reported by the committee, the provisions are to take effect as if included in the separate declaratory judgment provisions at the time those provisions were added to the Internal Revenue Code.

Revenue effect

These provisions have no effect on budget receipts.

33. Contributions of Certain Government Publications (sec. 2(ff) of the bill and sec. 1231 of the Code)

Present law

Under present law, U.S. Government publications received from the Government without charge or below the price at which they are sold to the general public are not to be treated as capital assets either in the hands of the taxpayer so receiving the publications or in the hands of a taxpayer whose basis in such a publication is determined by reference to its basis in the hands of a person who received it free or at a reduced price.

Reasons for change

Under the 1976 Act, these publications were excluded from the definition of "capital asset" under section 1221 of the Code. However, due to an oversight they were not similarly excluded from the definition of "property used in the trade or business" under section 1231(b) of the Code, and, therefore, could still be eligible for capital gains treatment in certain circumstances.

Explanation of provision

The bill, as amended by the committee, corrects this technical error and amends section 1231(b) to provide that the term "property used in

the trade or business" does not include U.S. Government publications received from the Government without charge or below the price at which they are sold to the general public.

There is no comparable provision in the House bill.

Effective date

The provision applies to sales, exchanges, and contributions made after October 4, 1976.

Revenue effect

This provision will involve a negligible increase in budget receipts.

34. Procedure for Claiming Exemption from Excise Tax on Certain Light-Duty Truck Parts (sec. 2(gg) of the bill and sec. 4063 of the Code)

Present law

The 8-percent manufacturers excise tax on sales of truck parts or accessories does not apply to parts sold for "further manufacture." Consequently, when the 10-percent excise tax on light-duty trucks (10,000 pounds or less gross vehicle weight) was repealed in 1971, accessories sold by the manufactuer of such a truck on or in connection with the sale of the trucks were freed from all manufacturers excise tax. However, parts or accessories added to a light-duty truck by a dealer continued to be subject to the 8-percent tax if the addition of the part was not considered by the Treasury Department to be further manufacture. An example of this is the attachment of a bumper by a retail dealer to a new light-duty truck.

As a step toward equalizing the tax treatment of parts or accessories attached to new light-duty trucks, the Tax Reform Act of 1976 provided that the 8-percent excise tax on truck parts and accessories is refunded or credited to the manufacturer if the part or accessory is sold on or in connection with the first retail sale of a light-duty truck. The result of this provision is to remove the 8-percent excise tax on these parts and accessories sold on or in connection with the first retail sale of a light-duty truck. However, the excise tax still must be paid initially by the manufacturer, and the manufacturer may not claim credit or refund until after the retail sale of the vehicle.

Reasons for change

It appears to the committee that the manufacturer of the light-duty truck parts that are going to be eligible for the tax refund or credit under present law should be able to make the sales tax-free initially so that the manufacturer does not have to wait until the claim for refund or credit is made to have the tax removed.

Explanation of provision

The bill, as amended by the committee, permits the tax-free sale by the manufacturer, producer, or importer of any truck part which is to be resold by the purchaser on or in connection with the first retail sale of a light-duty truck (as described in sec. 4061(a)(2)), or is to be resold by the purchaser to a second purchaser for resale by the second purchaser on or in connection with the first retail sale of a light-duty truck. The bill also gives the Treasury Department authority to require registration of sellers and purchasers before they may engage in tax-free sales and purchases of the parts eligible for exemption from the 8-percent excise tax. The registration system is now required for most categories of sales that may be made free of the manufacturers excise taxes.

There is no comparable provision in the House bill.

Effective date

The provision is effective for sales of eligible light-duty truck parts and accessories made on or after the first day of the first calendar month beginning more than 20 days after the date of enactment.

Revenue effect

This amendment is expected to have a negligible effect on budget receipts since it constitutes only a change in the administrative procedure for claiming the existing "exemption" for the eligible light-duty truck parts and accessories.

B. TECHNICAL AND CONFORMING AMENDMENTS TO ESTATE AND GIFT TAX PROVISIONS

1. Application of "Fresh Start" Provisions to Section 306 Stock (sec. 3(a)(1) of the bill and sec. 306(a) of the Code)

Present law

Under present law, special rules are provided to prevent the "bail out" of dividends as capital gains upon a sale or redemption of preferred stock previously distributed to shareholders. Under these rules, the amount realized from the sale or redemption of certain stock, known as "section 306 stock," is generally treated as dividend income. This treatment also applies to sales or redemptions of stock by a transferee if his basis is determined by reference to the basis of stock held by the transferor which was section 306 stock. Under the "stepped-up" basis rules in effect prior to the 1976 Act, inherited stock was not subject to dividend treatment under section 306 because the basis of the stock in the hands of his estate or his heirs was not determined by reference to the decedent's basis of the stock. However, under the carryover basis provisions of the 1976 Act, the decedent's basis for the stock is carried over, with certain adjustments, to the estate or the heir. Thus, dividend treatment under section 306 also carries over from the decedent to his estate or heirs.

In the case of a redemption of section 306 stock, the full amount of the redemption proceeds are treated as dividend income to the extent of the corporation's earnings and profits at the time of the redemption.[1] In the case of a sale of section 306 stock, the amount realized is treated as ordinary income to the extent of the ratable portion of the corporation's earnings and profits on the date of distribution of the stock. In both cases, the "fresh start" adjustment to basis provisions of the 1976 Act has no effect on the amount of the dividend income because the basis of the stock is irrelevant in making that determination. However, amounts realized in excess of the sum of the applicable portion of earnings and profits and the basis of the stock is treated as gain from the sale of the stock. Thus, the "fresh start" provisions can affect the amount of gain on the sale or redemption of the section 306 stock but only when the amount realized exceeds the sum of the applicable portion of the corporation's earnings and profits and the stock's basis on December 1976.

Reasons for change

The adoption of the carryover basis provisions has the effect of changing the taxation of section 306 stock sold or redeemed after death. Unlike the situation under prior law, the death of the recipient

[1] However, a distribution in redemption of section 306 stock to pay death taxes which qualifies under section 303 is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend income. See sec. 306 (b) (5) of the Code as added by sec. 3 (a) (2) of the bill.

of section 306 stock no longer removes the section 306 taint. Moreover, due to the operation of the rules for section 306 stock (described above), the "fresh start" adjustment of the carryover basis provisions provides only limited relief because the amount of basis is rarely important in section 306 situations. Since the purpose of the "fresh start" rule was, generally, to "grandfather" appreciation occurring prior to December 31, 1976, the committee believes that a special rule is needed to carry out this purpose in the case of section 306 stock which was issued before January 1, 1977.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides a special rule in the case of section 306 stock distributed before January 1, 1977, which is carryover basis property. However, under the committee bill, the special rule would apply only to stock passing or acquired from a decedent dying after December 31, 1979, in order to conform to the suspension of the carryover basis rules under the bill. For stock passing or acquired from a decedent before January 1, 1980, it is unnecessary to provide any special rule because the basis of the stock will be stepped-up in the hands of the estate or heir and, therefore, will not be subject to dividend treatment under section 306.

Under the special rule for section 306 stock which is carryover basis property, the amount treated as ordinary income on the sale or redemption of the stock may not exceed the amount realized over the sum of the adjusted basis of the stock on December 31, 1976, and the "fresh start" adjustment under the carryover basis rules. In the case of a redemption, this special rule applies only with respect to a redemption which would be treated as a sale or exchange if the stock were not section 306 stock. Amounts not treated as ordinary income or as a dividend will be treated as recovery of basis or gain in accordance with the usual rules under section 306(a)(1) or 301(c), as the case may be.

Effective date

The provision is effective for section 306 stock distributed before January 1, 1977, which is acquired from a decedent dying after December 31, 1979.

Revenue effect

The 3-year suspension of carryover basis removes any revenue effect from this provision until fiscal 1981, when it would reduce budget receipts by less than $1 million. It would reduce budget receipts by $5 million in fiscal 1982, by $7 million in fiscal 1983 and by gradually declining amounts through fiscal 1997 after which there is no revenue effect.

2. Redemptions of Certain Preferred Stock To Pay Death Taxes (sec. 3(a)(2) of the bill and sec. 306(b) of the Code)

Present law

Under present law (section 303), a distribution from a corporation to redeem its stock in order to pay death taxes and funeral and administration expenses is treated as an amount realized from the sale or exchange of a capital asset rather than as dividend (where certain requirements are met).

However, other provisions of the tax law (discussed above) are designed to prevent the "bail-out" of dividends as capital gain upon a sale or redemption of certain preferred stock distributed to shareholders. This stock is known as "section 306 stock." Because of the carryover basis provisions added by the 1976 Act, these special provisions apply to section 306 stock passing to the estate or heirs of the distributee shareholder.

It is presently unclear which of these two sets of rules takes precedence over the other; i.e., it is uncertain whether capital gains treatment is available for redemptions of sections 306 stock when all of the requirements of section 303 are met with respect to the stock.

Reasons for change

The committee believes that it should be made clear that redemptions of section 306 stock are eligible for capital gains treatment where the requirements for redemptions to pay death taxes and funeral and administration expenses (sec. 303) are met with respect to that stock. This treatment will facilitate the payment of death taxes and expenses and alleviate liquidity problems of estates consisting primarily of stock in closely held businesses.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that a redemption of section 306 stock is excepted from dividend treatment to the extent that the redemption meets the requirements for capital gains treatment with respect to redemptions to pay death taxes and funeral and administration expenses (sec. 303). Accordingly, a distribution in a qualifying redemption of such stock is to be treated as an amount realized from the sale or exchange of a capital asset.

Under the committee bill, the provision would apply to stock passing or acquired from a decedent dying after December 31, 1979, in order to conform to the suspension of the carryover basis rules under the bill. For stock passing or acquired from a decedent before January 1, 1980, it is unnecessary to provide any special rule because the basis of the stock will be stepped-up in the hands of the estate or heir and, therefore, will not be subject to dividend treatment under section 306.

Effective date

This provision is effective for redemptions of stock acquired from or passing from decedents dying after December 31, 1979.

Revenue effect

The 3-year suspension of carryover basis removes any revenue effect from this provision until fiscal 1981, when it would reduce budget receipts by less than $1 million. It would reduce budget receipts by $2 million in fiscal 19982 and by $3 million in fiscal 1983.

3. Deduction or Adjustment to Basis for Estate Tax on Appreciation (sec. 3(b) of the bill and sec. 691 of the Code)

Present law

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. This adjustment is designed to prevent

the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the recipient of the income is allowed a separate deduction for the death taxes attributable to that item of income in respect of a decedent (rather than as an adjustment to the basis of the property sold).

However, when the heir is entitled to long-term capital gain treatment, there may be a substantial disparity of treatment for income tax purposes between gains recognized by the heirs for property sold before death by the decedent and gains realized by the heirs upon a subsequent sale of inherited property. In the case of a sale before death, some courts have held that an individual is entitled to both the deduction for estate taxes attributable to the gain and the 50-percent long-term capital gain deduction based on the amount of gain undiminished by the deduction for estate taxes.[2] However, in the case of a sale of inherited property by an heir, the basis adjustments for death taxes attributable to appreciation would be taken into account in determining the amount of gain to which the 50-percent long-term capital gain deduction applies.

Reasons for change

The committee believes that capital gains recognized by heirs for property sold before death by the decedent should not be treated more favorably than gains realized by the heirs upon the sale of inherited property.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that, for purposes of computing the long-term capital gains deduction (or the amount of gain for purposes of the long-term capital gains alternative tax, and any net capital losses), the amount of the gain is to be reduced (but not below zero) by the amount of any applicable deduction for estate taxes attributable to a gain treated as income in respect of a decedent. For example, if a long-term capital gain of $100 is treated as income in respect of a decedent and the estate tax attributable to that gain is $30, the amount of the recipient's long-term capital gain which is subject to the alternative tax on capital gains would be $70 ($100 minus $30). In addition, the amount of the long-term capital gains deduction would be $35 (50 percent of $70) for all purposes (including the minimum tax). In either case, no additional deduction would be allowed for the estate taxes attributable to that gain.

No inference is to be drawn from the amendment as to the correct interpretation of present law.

Effective date

The provision is effective with respect to decedents dying after the date of enactment.

Revenue effect

This provision will increase budget receipts by less than $5 million per year.

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[2] It is possible that the combined deduction for estate taxes attributable to the income in respect of a decedent (up to 70 percent) and the capital gains deduction (50 percent) can exceed the amount of the capital gain and can be used to offset other ordinary income of the taxpayer.

4. Postponement of Effective Date of Carryover Basis Provisions (Sec. 3(c)(1) of the Bill and Sec. 1023 of the Code)

Present law

Under the Tax Reform Act of 1976, the basis of property passing from a decedent is "carried over" from the decedent to the estate or beneficiaries for purposes of determining gain or loss for sales and exchanges by the estate or beneficiaries. Under prior law, the basis of inherited property was generally stepped up or down to its value on the date of the decedent's death. The carryover basis provisions apply to property passing from decedents dying after December 31, 1976.

Reasons for change

A number of administrative problems concerning the carryover basis provisions have been brought to the attention of the committee. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Moreover, the committee believes that it should thoroughly review the basic concept of carryover basis for inherited property, as well as the administrative problems. The committee therefore believes that the effective date should be postponed in order to review the provisions before they become effective.

Explanation of provision

The bill postpones the effective date of the carryover basis provisions so that they will only apply to property acquired from decedents dying after December 31, 1978. For property passing or acquired from a decedent dying before January 1, 1980, the basis of property will be its fair market value at the date of the decedent's death or at the applicable valuation date if the alternate valuation provision is elected for estate tax purposes. Since the basis of farm and closely held business real property will not be carried over from the decedent for this period, the committee's bill provides that the basis of that real property will be the amount determined under the special valuation provision if elected for estate tax purposes rather than fair market value based on its highest and best use.

The committee's bill also postpones the effective date of the changes made by the 1976 Act relating to the deduction for estate taxes attributable to income in respect of a decedent. Under the bill for the postponement period, the deduction will be based on the highest marginal rates rather than the average rate and will be determined only for Federal estate taxes rather than for both Federal and State death taxes. As a conforming change, the basis of property included in a generation-skipping transfer which occurs during the postponement period, as a termination by reason of the death of the deemed transferor, will be determined in the same manner as for property acquired from or passing from a decedent during the postponement period.

The House bill did not provide for the postponement of these provisions.

Effective date

The amendments are to take effect as if included in the Tax Reform Act of 1976. Thus, the postponement applies to property passing or acquired from a decedent dying after December 31, 1976, and before January 1, 1980.

Revenue effect

This provision will reduce budget receipts by $36 million in fiscal 1979, by $93 million in fiscal 1980, by $162 million in fiscal 1981, by $133 million in fiscal 1982, by $110 million in fiscal 1983, and by smaller amounts each fiscal year through 1999. Beyond 1999, there would be a negligible effect upon budget receipts.

5. Fresh Start Adjustment for Certain Carryover Basis Property (sec. 3(c)(2) of the bill and sec. 1023(h) of the Code)

Present law

Under present law, the basis of an asset acquired from or passing from a decedent, generally, is its basis in the hands of the decedent (i.e., the basis is "carried over") increased by certain adjustments. One of the adjustments permits the basis of an asset held on December 31, 1976, to be increased to its fair market value on that date (the so-called "fresh-start" adjustment). This adjustment was intended to exclude appreciation occurring before 1977 from the carryover basis rule.

In the case of property which was a marketable bond or security, the fair market value on December 31, 1976, is its value on that date. Where, however, the property is not a marketable bond or security, the fair market value of the property on December 31, 1976, is determined under a formula which assumes that the property appreciated evenly over the holding period. Generally the aggregate appreciation will be allocated to pre-1977 holding periods on the basis of the number of days the asset was held prior to January 1, 1977, over the total number of days the asset was held by the decedent. In order to apply the formula, the date the asset was acquired and its basis must be known. Where the decedent's basis cannot be determined after reasonable efforts by the executor, but the date (or approximate date) or acquisition is known, a special rule permits the executor and the Internal Revenue Service to assume that the decedent's basis was the fair market value of the property on the date (or approximate date) of acquisition.

Reasons for change

In some cases, it is particularly difficult for the executor to determine either the decedent's basis or the date (or approximate date) of acquisition of the property. This is especially likely to occur where the property is tangible personal property, such as an item of art, an antique, or a coin or stamp collection. In such a case, literal application of the present rules would result in loss of all benefit from the "fresh start" provision.

For these reasons, the committee believes that a special rule should be provided so that the executor can determine the fresh start adjustment without having to ascertain the decedent's basis and the date (or approximate date) of acquisition of the property.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides a formula to determine a minimum basis which reflects the fresh start adjustment for certain property. This provision applies on a property-by-property basis for determining the basis of eligible fresh

start property (the $60,000 "minimum basis" adjustment applicable to aggregate bases would continue to apply as under present law).

Only property which is tangible personal property is eligible for the new provision. Thus, stocks, bonds, and other intangible assets are not eligible for this minimum basis rule.

In addition, the executor or heir must establish that the decedent held the property (or was considered to hold substituted property) on December 31, 1976 in order for the new provision to apply.

For eligible property, the adjusted basis is treated as being not less than its value on the date of the decedent's death discounted for the period of time from December 31, 1976, to the date of the decedent's death (taking into account full calendar months). Under the formula, the post-1976 appreciation is assumed to accrue at approximately 8 percent a year.

Effective date

This provision is effective with respect to property passing or acquired from a decedent dying after December 31, 1979, which was held by the decedent on December 31, 1976.

Revenue effect

This provision will reduce budget receipts by less than $5 million per year beginning in fiscal 1981.

6. Treatment of Indebtedness Against Carryover Basis Property (sec. 3(c)(3) of the bill and sec. 1023(g) of the Code)

Present law

Under present law, the basis of assets acquired from or passing from a decedent, generally, is its basis "carried over" from the decedent increased by certain adjustments. Two of these adjustments permit the basis of appreciated assets to be increased by the Federal and State death taxes attributable to the appreciation (secs. 1023 (c) and (e)). Generally, these adustments are made by apportioning the death taxes to individual items of property on the basis of the appreciation for that item as compared to the fair market value of all property included in the gross estate.

In the case of property subject to an indebtedness for which the decedent was personally liable, the full fair market value of the property is included in the gross estate and a separate deduction is taken for the indebtedness. However, in the case of property subject to an indebtedness for which the decedent was not personally liable, the value of the decedent's equity in the property (i.e., the value of the property minus the indebtedness) is included in the gross estate. In this latter case, the apportionment of the death tax basis adjustment is made in reference to the value of the decedent's equity in the property.

Reasons for change

The committee believes that the present rule for apportioning the death tax adjustment may result in misallocating the adjustments between property subject to a nonrecourse debt and other property.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that, for purposes of the basis adjustments, the fair market value of property is to be determined without regard to whether

there is a mortgage on, or indebtedness in respect of, the property. Thus, the full value of the property unreduced by any indebtedness on the property is to be used for all purposes (i.e., the adjustment for State and Federal death taxes, the amount of the gross estate, and the amount of the appreciation) in computing the basis adjustments regardless of how the value of the property and the debt are reported for estate tax purposes.

Effective date

The provision is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year beginning in fiscal 1981.

7. Only One Fresh Start With Respect to Carryover Basis Property Held on December 31, 1976 (sec. 3(c)(4) of the bill and sec. 1023(h) of the Code)

Present law

Under present law, the "fresh start" adjustment is permitted for property passing from a decedent where that property reflects the basis of any asset held by him on December 31, 1976. Present law does not explicitly prevent successive fresh start adjustments for property when it is successively devised, bequeathed, or transferred by interstate succession or survivorship rights by more than one decedent.

Reasons for change

The committee believes that it should be made clear that the "fresh start" adjustment is to be made only once.

Explanation of provision

The bill, as passed by the House and reported by the committee, amends the carryover basis provisions to provide that the fresh start adjustment will not apply where the adjusted basis of property passing from a decedent (i.e., the heir of the prior decedent) reflects the adjusted basis of property which was carryover basis property with respect to a prior decedent. However, in the case of carryover basis property which is jointly held with rights of survivorship, a fresh start adjustment is to be allowed upon the death of a surviving joint tenant for that portion of the property that was not included in the estate of the joint tenant who died first.

Effective date

The provision is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision has no effect upon budget receipts.

8. Holding Period for Carryover Basis Property (sec. 3(c)(5) of the bill and sec. 1223 of the Code)

Present law

Prior to the 1976 Act, all property which received a "stepped-up" basis was deemed to have been held by the estate or heirs for the period required for long-term capital gains treatment (sec. 1223(11)).

Under the 1976 Act, the basis of property acquired from or passing from a decedent, generally, is its basis in the hands of the decedent (i.e., a carryover basis). Because the basis of these assets is "carried over" to the heir or estate and is not "stepped-up" (under sec. 1014), those assets are not deemed to be held for the period required for long-term capital gain treatment.

Reasons for change

The committee believes that the change in the basis rules made by the 1976 Act was not intended to convert what was previously long-term capital gain or loss into short-term capital gain or loss. The committee believes that estates and heirs should continue to receive the favorable treatment accorded long-term capital gains even though the combined holding period of the decedent and the estate (or heir) is less than the holding period necessary for long-term status.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that carryover basis property is deemed to be held by the estate or heirs for the period required for long-term capital gain treatment.

Effective date

This amendment is effective for property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year beginning in fiscal 1981.

9. Adjustment to Carryover Basis Property for State Estate Taxes (sec. 3(c)(6) of the bill and sec. 1023(c) of the Code)

Present law

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for Federal and State death taxes attributable to appreciation. With respect to State estate taxes, the adjustment is made to property subject to tax for Federal estate tax purposes. However, where the inclusion rules, or charitable and marital deduction rules, for State and Federal estate tax purposes are different, the present rule does not take these differences into account for making the basis adjustment for State estate taxes.

Reasons for change

The committee believes that the basis of property should be entitled to be increased by any inheritance or other State death taxes that are actually imposed on that property regardless of whether that property is subject to Federal estate tax. Accordingly, the committee believes that the adjustment to basis for State estate taxes should be made by reference to the property that is subject to tax under the applicable State laws.

Explanation of provision

The bill, as passed by the House and reported by the Committee, provides that the basis adjustment for State estate taxes on the appreciation is to be determined by reference to the inclusion and

valuation rules of the applicable State law. However, the amount of appreciation in any property will continue to be determined under Federal income tax rules.

Effective date

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year beginning in fiscal 1981.

10. Clarification of Increase in Basis for Certain State Succession Taxes (sec. 3(c)(7) of the bill and sec. 1023(e) of the Code)

Present law

Under the carryover basis provisions as added by the 1976 Act, an adjustment to basis is permitted for State death taxes attributable to appreciation that are paid by the heir and for which the estate is not liable (sec. 1032(e)). This adjustment was intended to apply to State inheritance and succession taxes actually paid by an heir. However, under most State laws, the estate is technically liable for the payment of these taxes and, as a result, it is somewhat unclear as to whether an adjustment would be permitted in cases where the beneficiary pays the taxes.

Reasons for change

The committee believes that the adjustment to basis of property for State death taxes attributable to appreciation in that property should be permitted even though the decedent's estate is technically liable for the payment of the death taxes.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes it clear that the adjustment for State death taxes attributable to appreciation in property will be available for State death taxes actually paid by an heir (or trust for the benefit of heirs) even though the estate of the decedent is technically liable for the payment of the tax.

Effective date

The amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision has no effect upon budget receipts.

11. Coordination of Carryover Basis Adjustments (sec. 3(c)(8) of the bill and sec. 1023(h) of the Code)

Present law

Under the carryover basis provisions of present law, adjustments to basis are permitted for (1) the so-called "fresh-start" adjustment to reflect fair market value at December 31, 1976, (2) the Federal and State estate taxes attributable to appreciation, (3) a minimum basis of $60,000, and (4) State inheritance taxes attributable to appreciation paid by the heir. Under the order prescribed for making these adjust-

ments, the fresh start adjustment would be made first. The fresh start adjustment would then affect the amount of the other adjustments since it would be taken into account in measuring the amount of appreciation for purposes of the death tax adjustments and in determining whether the basis of all properties was less than the $60,000 minimum basis. However, the fresh start adjustment is taken into account only for purposes of determining gain from the sale or other disposition of the property by the estate or heirs and cannot be used to generate a loss from the sale or other disposition of the property.

Reasons for change

It has been brought to the committee's attention that it is somewhat unclear whether recomputations of the death tax adjustments and the minimum basis adjustments for each item of property may be required every time any heir sells property.

Explanation of provision

The bill, as passed by the House and reported by the committee, clarifies that no recomputation of basis is required for the death tax or minimum basis adjustments. Basically, the basis of "fresh start" property for loss purposes would be the same as for gain purposes except that it would not reflect the fresh start adjustment.

Effective date

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provision has no effect upon budget receipts.

12. Basis for Certain Term Interests (sec. 3(c)(9) of the bill and sec. 1001(e) of the Code)

Present law

In determining the amount of gain or loss from the sale of a term interest (such as a life estate, term of years, or an income interest in a trust), the basis of property acquired or passing from a decedent or transferred by gift is not generally taken into account by the holder of the term interest. A conforming amendment was not made under the 1976 Act to apply this provision to carryover basis property.

Reasons for change

The committee believes that the basis for determining gain or loss for sales or exchanges of term interests in carryover basis property should be subject to the general rules applicable to sales or exchanges of term interests.

Explanation of provision

The bill, as passed by the House and reported by the committee, applies the basis rule for sales or other dispositions of term interests to carryover basis property.

Effective date

This amendment is effective with respect to property acquired from or passing from a decedent dying after December 31, 1979.

Revenue effect

This provison has no effect upon budget receipts.

13. Clarification of the Rules Relating to Special Use Valuation (sec. 3(d)(1) of the bill and sec. 2032A of the Code)

Present law

Under the 1976 Act, if certain conditions are met, "qualified real property" may be valued for estate tax purposes at its farm or business use value, rather than at its value based on "highest and best" use. To qualify for the special use valuation rule, several requirements must be satisfied. First, the real property must have been owned by the decedent (or a member of his family) and used for farm or business purposes for five of the eight years preceding the decedent's death. Second, a substantial portion of the adjusted gross estate must consist of qualified property, i.e., 50 percent must consist of real and personal property used in the business and 25 percent must consist of real property used in the business. Third, the qualified property (the portion satisfying the 50- and 25-percent tests) must pass to members of the decedent's family (known as "qualified heirs"). Also, the decedent or a member of his family must have materially participated in the business in which the property is used for five of the eight years preceding the decedent's death.

Reasons for change

Under present law, it is not clear whether, if the estate otherwise qualifies for the portion satisfying the percentage tests, other property which is used in a qualifying use can be valued under the special use valuation rules when it passes to nonfamily members—that is, persons who are not qualified heirs.

The intent of Congress was to provide special use valuation only for property which remained in the hands of the decedent's family and which was being used for a qualified use both before and after the decedent's death.

Explanation of provision

The bill, as passed by the House and reported by the committee, explicitly provides that real property is eligible for special use valuation only to the extent that it passes to qualified heirs. (With respect to property "passing" to a qualified heir, see the discussions immediately following.)

Effective date

This provision applies to the estates of decedents dying after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

14. Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(2) of the bill and sec. 2032A of the Code)

Present law

Under the Tax Reform Act, qualified real property which passes from a decedent to a qualified heir is generally eligible for special valuation rules. Under present law, the distribution of property by an estate or trust in satisfaction of a pecuniary bequest is treated as a taxable transaction resulting in the recognition of gain or loss to the estate. Under the tax law, for most purposes, if property is distributed

in a taxable transaction, the property is not considered to have been acquired from or passed from a decedent.

Reason for change

Due to the interaction of the rules described above, there is a technical question as to whether property otherwise qualifying for the special estate tax valuation rule will qualify if it is distributed pursuant to a pecuniary bequest.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that, under the special use valuation provision, property shall be considered to have been acquired from, or to have passed from, a decedent if it is acquired by any person from the estate in satisfaction of the right of the person to a pecuniary bequest (as well as if it was acquired from the decedent by a specific bequest or the equivalent of a pecuniary bequest). Thus, property will not become ineligible for the special valuation rule solely because it is distributed to a qualified heir in satisfaction of a pecuniary bequest.

Effective date

This provision applies to estates of decedents dying after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

15. Gain Recognized on Use of Special Use Valuation Property to Satisfy Pecuniary Bequest (sec. 3(d)(3) of the bill and sec. 1040 of the Code)

Present law

Under present law, the distribution of property by an estate or trust in satisfaction of a pecuniary bequest is treated as a taxable transaction resulting in the recognition of gain or loss to the estate.

Under the law prior to the 1976 Act, the amount of gain recognized on a distribution in satisfaction of a pecuniary bequest was limited to post-estate tax valuation date appreciation because the estate received a stepped-up basis for the property. As a conforming change under the carryover basis provisions added by the 1976 Act, the Act also provided that, where an estate distributes property in satisfaction of a pecuniary bequest, gain is recognized by the estate only to the extent of the appreciation occurring from the estate tax valuation to the date of distribution.

The limitation on gain recognized by the estate was intended to provide substantially the same income tax treatment provided under prior law for a pecuniary bequest distribution. However, under the 1976 Act, the amount of post-death appreciation is considered to be the difference between the value of the property for estate tax purposes and its fair market value on the date of distribution. Thus, if the statute is literally applied where property is subject to special farm or other business use valuation, a portion of the pre-death appreciation will be included in the gain recognized by the estate because the gain would be the excess of the value at the time of distribution over the special use value used for estate tax purposes.

Reasons for change

Where property qualifies for special farm or other business use valuation, it was not the intent of Congress to subject the benefit from the special use valuation to income tax upon distribution of the property to satisfy a pecuniary bequest.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the special use valuation provision is not to be taken into account in determining the post-death appreciation subject to income tax when an estate or trust satisfies a pecuniary bequest with appreciated property. Thus, the appreciation subject to tax will be measured by the difference between the fair market value of the property on the date of distribution (without regard to special use valuation) and the fair market value of the property on the date of the decedent's death or the alternate valuation date (determined without regard to the special use valuation provision).

Effective date

This provision applies to estates of decedents dying after December 31, 1979.

Revenue effect

This provision will have a negligible effect upon budget receipts.

16. Treatment of Community Property Under Special Use Valuation Provision (sec. 3(d)(4) of the bill and sec. 2032A of the Code)

Present law

Under present law, it is unclear whether the special use valuation provision for qualified real property applies in the same manner to property held as community property as it does to property held by the decedent as his individual property in a common law State.

Reasons for change

The committee wishes to clarify the present law so that the special use valuation provision is to apply to community property in the same manner as property that is not community property.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes it clear that the special use valuation provision is to apply to community property in the same manner as property owned by the decedent in his individual capacity. For example, the entire value of the property will be taken into account for purposes of determining if the percentage qualification requirements are satisfied.

Effective date

This provision is effective with respect to estates of decedents dying after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

17. Substitution of Bond for Personal Liability of Qualified Heir for Recapture of Tax with Respect to Special Use Valuation Property (sec. 3(d)(5) of the bill and sec. 2032A of the Code)

Present law

Under present law, if an executor of an estate elects to value certain qualifying real property under the special use valuation provision, there are certain circumstances which would result in the recapture of the estate tax savings. All or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are to be recaptured if, within 15 years after the death of the decedent (but before the death of the qualified heir), the qualifying property is disposed of to nonfamily members, the qualifying property ceases to be used for farming or other closely held business purposes, or the family members cease to materially participate in the farm or other closely held business.

Under this provision, the qualified heir is personally liable for the recapture tax imposed with respect to his interest in qualified real property, and there is a lien on the qualified real property. There is no provision which would relieve the qualified heir of his personal liability, even though he is willing to provide a bond to secure the amount of his personal liability.

Reasons for change

The committee believes it is appropriate to allow a qualified heir to be relieved of potential personal liability if an appropriate bond is furnished.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that a quaified heir may be discharged from personal liability and shall be entitled to a receipt or writing showing this discharge if he furnishes a bond which meets certain requirements. In order to comply with this bond procedure, the qualified heir must make written application to the Secretary of the Treasury for a determination of the maximum amount of the additional tax which may be imposed by the special farm valuation provision with respect to his interest. The Secretary is required to notify the heir of the maximum amount of the recapture tax as soon as possible and, in any event, within one year after the making of the application. If the qualified heir furnishes a bond in this amount and for such period as may be required (which, in general, should be no longer than the period to which the recapture tax applies), he shall be discharged from personal liability.

The maximum amount of the bond does not include interest on the amount of the qualified heir's personal liability, even though interest may accrue on the amount of the recapture tax imposed from the date of imposition until the date the tax is paid.

Effective date

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

Revenue effect

This provision will have no effect on budget receipts.

18. Security Where Extended Payment Provisions are Elected (sec. 3(e) of the bill and sec. 6324A of the Code)

Present law

Under present law as amended by the 1976 Act, there are two provisions permitting extended payment of estate taxes (over 15- or 10-year periods), where a farm or closely held business constitutes a substantial portion of the decedent's estate. Prior to the 1976 Act, where extended payment was elected, the executor was generally personally liable for the deferred estate taxes unless he posted bond equal to double the amount of the unpaid tax.

The 1976 Act permitted the executor to be relieved from personal liability for the unpaid tax where either of these extended payment provisions is elected. Instead, if elected, a lien attaches to real property and other assets with long useful lives until the deferred taxes are paid. The amount of the lien is equal to the deferred tax liability plus the total amount of interest which will be payable on the deferred taxes.

Reasons for change

The committee does not believe it is necessary to require security for the amount of the deferred taxes plus the full amount of the interest payable over the deferral period. If a payment of tax is missed or another event occurs which accelerates the payment of the tax, collection would ordinarily be completed within a relatively short time after the accelerating event. Consequently, it appears that adequate security to protect the Government's interest would be provided if the maximum amount of security included the amount of the deferred tax liability plus an amount equal to the interest payable for the first four years of the payment period.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the maximum amount of property which is to be required to be subject to a lien if the executor elects to be discharged from personal liability (under sec. 6324A) shall not be greater than the sum of the deferred amount of the unpaid estate tax liability plus the aggregate amount of interest which would be payable over the first four years of the period over which the tax liability is deferred. It is anticipated that the IRS will permit a reduction in the maximum amount as deferred taxes and interest are paid. Also, in cases where sufficient property is not available or offered to be subject to the lien, the difference between this maximum amount of the amount of property tendered can be satisfied by the furnishing of a bond.

Effective date

This provision applies to the estates of decedents dying after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

19. Transfers Within Three Years of Death (sec. 3(f) of the bill and sec. 2035 of the Code)

Present law

Under the 1976 Act, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were actually made in contemplation of death. However, the 1976 Act provided an exemption to the automatic three-year inclusion rule for gifts excludable under the $3,000 annual gift tax exclusion. Under this exception, the legislative history indicated that the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts.

Reasons for change

The committee is concerned that this rule will impose serious administrative burdens upon executors as it will be necessary to ascertain whether the decedent had made gifts during the 3-year period (even though no return was required), and, if there were any gifts, the value of the gifts at the time of the donor's death.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the exception to the transfer within 3 years of death estate tax inclusion rule applies to gifts made to a donee where no gift tax return was required to be filed with respect to the gifts, e.g., gifts of present interests to a donee that do not exceed $3,000 in a calendar year. If the gifts are required to be shown on a gift tax return, the gifts made within three years of the decedent's death are required to be included in the decedent's gross estate. For example, a gift of a present interest in property valued at $3,500 which is made within 3 years of death would be includible in the donor's gross estate even though the gift was fully excludable because the other spouse consented to be treated as the donor of one-half of the gift.

This exception does not apply to any transfer with respect to a life insurance policy. However, the exception does apply to any premiums paid (or deemed paid) by the decedent within 3 years of the death to the extent that such payments would not have resulted in the inclusion of the proceeds of the policy in the decedent's gross estate under prior law. On the other hand, the exception does not apply to any transfer which would have resulted in inclusion in the gross estate of the proceeds of the policy under law prior to the 1976 Act if the transfer were made within 3 years of death.

Effective date

This provision applies to estates of decedents dying after December 31, 1976, except that it does not apply to transfers made before January 1, 1977.

Revenue effect

This provision will have no effect on budget receipts.

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20. Coordination of Gift Tax Exclusion and Marital Deduction and Estate Tax Marital Deduction (secs. 3(g)(1) and (2) of the bill and secs. 2035 and 2056 of the Code)

Present law

Under present law, as amended by the 1976 Act, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of $200,000. (The 1976 Act did not change the ordering rule of section 2524, i.e., the annual exclusion is taken into account first before a portion of the gift to a spouse is considered to be deductible under the marital deduction provision.)

In addition, where interspousal lifetime transfers are less than $200,000, the allowable estate tax marital deduction is reduced (or "cut-down") by the excess of the gift tax marital deduction with respect to gifts made after 1976 over 50 percent of the value of such gifts. However, where the unlimited $100,000 gift tax marital deduction has been used up but the aggregate gifts of a spouse do not exceed $200,000, the present formula will reduce the estate tax marital deduction "cut-down" where subsequent gifts of $3,000 or less are made to a spouse during a year (which are excluded from tax and for which a gift tax return is not required) because the "cut-down" is reduced by one-half the value of such subsequent gifts. In addition, no exception to the restoration of the "cut-down" in the allowable estate tax marital deduction is made where an interspousal lifetime gift is brought back into the estate of the donor spouse by reason of section 2035 (relating to transfers within 3 years of death).

Reasons for change

Because no gift tax return is required to be filed where the total gifts to a donee (other than gifts of a future interest) do not exceed $3,000 per year, the committee wishes to relieve executors of the administrative difficulties in determining the amount of these small gifts for purposes of computing the allowable marital estate tax deduction. Further, where property which was given to the decedent's spouse is included in the decedent's estate by reason of section 2035, the committee believes that the estate tax marital deduction should not be reduced because inclusion in the gross estate will negate any benefit derived from the gift tax marital deduction.

Explanation of provision

The bill, as passed by the House and reported by the committee, amends the estate tax marital tax deduction in two respects. First, it excludes any gift not required to be included in a gift tax return from the computation of the estate tax marital deduction "cut-down" (under section 2056(c)(1)(B)). Second, it provides that the estate tax marital deduction will not be reduced on account of any gifts to the surviving spouse which were included in the decedent's estate solely by reason of section 2035.

Effective date

This provision applies with respect to estates of decedents dying after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

21. Split Gifts Made Within Three Years of Death (sec. 3(h) of the bill and sec. 2001 of the Code)

Present law

Under the gift tax law, a spouse may consent to be treated as the donor of one-half of a gift made by the other spouse to a third party. This is referred to as "gift splitting." Under the 1976 Act, where the donor spouse dies within 3 years of making a "split gift," the entire gift is included in the donor spouse's estate and any gift tax actually paid by the consenting spouse on the gift is allowed as a credit in determining the estate tax for the estate of the donor spouse. However, the transfer tax consequences to the consenting spouse are not reversed. For example, any unified credit used is not restored and the amount of aggregate taxable gifts for prior periods is not adjusted.

Reasons for change

The committee believes that, where a spouse consents to be treated as the donor of one-half of a gift to a third party but the full amount of the gift is included in the other spouse's estate, the estate tax for the consenting spouse should be determined without regard to that gift since the benefits of gift splitting have been generally eliminated by inclusion of the gift in the other spouse's gross estate.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides for the reversal of the transfer tax consequences of gift splitting to the estate of the consenting spouse if the gift is included in the gross estate of the donor spouse as a transfer made within three years of death. In computing the estate tax for the consenting spouse, the bill excludes the gift in determining the amount of lifetime transfers under the unified transfer system. However, the gift tax paid by the consenting spouse would not be taken into account as a credit against the estate tax of the consenting spouse if it had been allowed as a credit to the estate of the donor spouse.

Effective date

This provision applies with respect to the estates of decedents dying after December 31, 1976, except that it does not apply to transfers made before January 1, 1977.

Revenue effect

This provision will have no effect on budget receipts.

22. Inclusion in Gross Estate of Stock Transferred by the Decedent Where the Decedent Retained Voting Rights (sec. 3(i) of the bill and sec. 2036(b) of the Code)

Present law

Under present law, the retention of certain powers or interests by a decedent in property transferred by the decedent during his lifetime results in the property being includible in his gross estate for estate tax purposes (sec. 2036). The 1976 Act extended this rule to the retention of voting rights in stock of any corporation which was

transferred by the decedent during his lifetime even if the corporation was not a controlled corporation. This rule is often called the "anti-*Byrum*" rule because it was intended to overrule the result reached in that case by the U.S. Supreme Court.

Reasons for change

The rule in the 1976 Act required the inclusion of any stock over which the decedent retained a power to vote regardless of whether the corporation was controlled by the decedent. The committee believes that the retention of voting power should result in the inclusion of the stock in the decedent's gross estate only where the decedent and his relatives own 20 percent or more of the voting stock of the corporation.

In addition, the committee believes that the rule should be clarified with respect to the retention of voting rights in certain indirect transfers as well as direct transfers of stock in a controlled corporation.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes two amendments to the rule contained in the 1976 Act. First, the bill restricts the rule to stock in corporations which are controlled by the decedent and his relatives. Second, the bill clarifies the rule under the 1976 Act that indirect transfers are subject to the rule.

Under the bill, the rule requiring inclusion in the gross estate only applies to stock in a "controlled corporation." Where the stock is not in a "controlled corporation", the stock is not included in the gross estate of the decedent even if the decedent directly held the power to vote those shares.

A "controlled corporation" is defined to mean a corporation where the decedent and his relatives owned, or had the power to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock. The constructive ownership rules of section 318 apply solely for purposes of determining whether the corporation is a controlled corporation. In addition, in order for the corporation to be controlled, the ownership of, or power to vote, 20 percent of the total combined voting power of all classes of stock had to occur any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death.

The rule requiring inclusion in the gross estate of stock of a controlled corporation applies where the decedent retained the voting rights of the stock which was directly or indirectly transferred by him. Thus, where the decedent transferred cash or other property prior to his death to a trust of which he is trustee within 3 years of his death, and then the trust uses that cash or other property to purchase stock in a controlled corporation from himself, the value of the stock would be included in his gross estate. In addition, the indirect retention of voting rights in the case of reciprocal transfers of stock in trust would result in the inclusion of the stock with respect to which the decedent had voting rights as trustee. However, voting rights in stock transferred in trust by the decedent will not be considered to have been retained by the decedent merely because a relative was the trustee who voted the stock. In these cases, the voting rights would be considered to have been indirectly retained by the decedent if in substance the decedent had retained such voting rights, e.g., there had been an ar-

rangement or agreement for the trustee to vote the stock in accordance with directions from the decedent.

The rule would not apply to the transfer of stock in a controlled corporation where the decedent could not vote the transferred stock. For example, where a decedent transfers stock in a controlled corporation to his son and does not have the power to vote the stock any time during the 3-year period before his death, the rule does not apply even where the decedent owned, or could vote, a majority of the stock. Similarly, where the decedent owned both voting and nonvoting stock and transferred the nonvoting stock to another person, the rule does not apply to the nonvoting stock simply because of the decedent's ownership of the voting stock.

Effective date

This provision is effective with respect to decedents dying after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

23. Estate Tax Exclusion for Certain Retirement Benefits (sec. 3(j)(1) of the bill and sec. 2039(d) of the Code)

Present law

Under present law as amended by the 1976 Act, in general, the value of an annuity receivable by a beneficiary (other than the executor) under an individual retirement account is excluded from a decedent's gross estate. The exclusion applies only to the portion of the account attributable to contributions which were allowable as a deduction for income tax purposes or attributable to rollover contributions from a tax-qualified plan.[3]

This exclusion specifically refers to individual retirement accounts, individual retirement annuities, and retirement bonds for which a deduction was allowable under section 219 of the Code but does not refer to the new spouse-covered plans for which a deduction is allowable under section 220.

Reasons for change

The committee believes an individual retirement account for an individual and his spouse should be treated in the same way as other individual retirement accounts for purposes of the estate tax exclusion.

Explanation of provision

The bill, as passed by the House and reported by the committee, makes it clear that annuities receivable by a beneficiary (other than the executor) under a spouse-covered individual retirement account (sec. 220) may qualify for the estate tax exclusion.

Effective date

This provision applies to estates of decedents dying after December 31, 1976.

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[3] However, the estate tax exlusion is limited to an annuity receivable under a qualifying program.

Revenue effect

This provision will have no effect on budget receipts.

24. Annual Exclusion for Spouse's Interest in an Individual Retirement Account (sec. 3(j)(2) of the bill and sec. 2503 of the Code)

Present law

Under present law as modified by the 1976 Act, an eligible individual can contribute up to $875 to his own IRA and $875 to an IRA separately owned by a spouse, or can contribute up to $1,750 to an IRA which credits $875 to a subaccount for the husband and $875 to a subaccount for his wife ("SIRA").

A taxpayer who makes a gift to another person is generally subject to a gift tax on the amount of such gift. However, present law provides an annual exclusion of $3,000 per donee for a donor to the extent that the donee receives a present interest in the property.

Under the SIRA rules, the spouse of the individual establishing the account or annuity must be given a vested interest in the account or annuity. However, since the spouse cannot receive benefits from the SIRA until age 59½, without a significant tax penalty, the contribution made on behalf of the spouse would probably be treated as a transfer of a future interest and not eligible for the $3,000 annual per donee exclusion.

Reasons for change

The committee believes that the spouse's interest in an individual retirement account should be considered a present interest eligible for the gift tax annual exclusion.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the contribution by an individual to a SIRA for his spouse (whether in the form of an individual retirement account, individual retirement annuity, or retirement bond) constitutes a gift of a present interest in property (within the meaning of section 2503) rather than a gift of a future interest. Consequently, the amount of the contribution for the benefit of a spouse is eligible to be treated as a portion of the $3,000 annual exclusion of gifts to the spouse.

Effective date

This provision applies to tranfers made after December 31, 1976.

Revenue effect

This provision will have no effect on budget receipts.

25. Gift Tax Consequences From the Creation of a Joint Tenancy in Personal Property (sec. 3(k)(1) of the bill and sec. 2515A of the Code)

Present law

Under present law, the creation of a joint tenancy in personal property with rights of survivorship constitutes a gift to the extent that the contribution made by a tenant exceeds the tenant's retained interests in the property. A similar rule applies in the case of a joint tenancy

created in real property without rights of survivorship between spouses. In the case of a joint tenancy in real estate with rights of survivorship between spouses, no gift tax is imposed unless the donor spouse elects to treat the creation of the joint tenancy as a gift. Prior to the 1976 Act, when an election was made, the amount of the donor spouse's retained interest in realty was determined by use of actuarial factors if, under applicable local law, neither joint tenant could unilaterally sever the joint tenancy.

The 1976 Act eliminated the need to use actuarial calculations in the case of the creation of a joint tenancy by the husband and wife in real property. Under the Act, the retained interest of each spouse is considered to be one-half the value of the property even if neither joint tenant can unilaterally sever the joint tenancy. However, the rule eliminating the use of actuarial values did not apply to the creation of a joint tenancy between husband and wife in personal property.

Reasons for change

The committee believes that the rules adopted in the 1976 Act to simplify the determination of the amount of the gift in the case of joint tenancies in real property should also apply with respect to the creation of a joint tenancy in personal property.

Explanation of provision

The bill, as passed by the House and reported by the committee, generally eliminates actuarial calculations in determining the amount of a gift with respect to the creation of a joint tenancy between husband and wife in personal property. However, actuarial calculations will continue to be required if the fair market value of the joint interest of the personal property cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. Thus, for example, the amount of a gift would continue to be determined actuarially in the case of a gift involving a joint and survivor annuity.

Effective date

The provision applies to joint interests created after December 31, 1976.

Revenue effect

This provision will reduce the budget receipts by less than $1 million per year.

26. Fractional Interest Rule for Certain Joint Tenancies (sec. 3 (k)(2) of the bill and sec. 2040 of the Code)

Present law

Prior to the 1976 Act, the estate tax law provided that on the death of a joint tenant, the entire value of the property owned in joint tenancy was included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor.

The 1976 Act added a provision which provided that in the case of a "qualified joint interest" created after December 31, 1976, one-half of the value of a joint interest would be included in an estate of the first tenant to die. A qualified joint interest is a joint tenancy between a decedent and his spouse created by one or both spouses, the creation

of which in the case of personal property constituted a gift in whole or in part or, in the case of real property, as to which an election was made to treat the creation as a transfer of property. Although the 1976 Act made no change with respect to joint interests created before January 1, 1977, a taxpayer can receive the benefit of the new fractional interest rule by severing an existing joint tenancy and re-creating it if the re-creation is subject to a gift tax.

Reasons for change

The committee believes that a donor spouse should be allowed to have a pre-1977 joint tenancy treated as a "qualified joint interest" without going through a formal severance and re-creation of the joint tenancy.

Explanation of provision

The bill, as passed by the House and reported by the committee, allows a donor spouse to have a pre-1977 joint tenancy to be treated as a "qualified joint interest" without formally severing the joint tenancy and then re-creating it. This treatment is to be available if the taxpayer elects to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979. A taxpayer making the election is to be treated as having made a gift at the close of calendar quarter for which the return is filed. The amount of the gift generally is to be equal to the appreciation attributable to the gift portion of the consideration furnished by the donor spouse at the time of the creation of the joint interest.

Effective date

This provision applies to a joint tenancy created before January 1, 1977, if the donor makes a timely election under this provision for any calendar quarter in 1977, 1978, or 1979.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

27. Orphans' Exclusion Where There is a Trust for Minor Children (sec. 3(l) of the bill and sec. 2057 of the Code)

Present law

The 1976 Act provided a new deduction for estate tax purposes for amounts passing from the decedent to his orphaned children. The deduction with respect to each child is limited to $5,000 multiplied by the number of years that the child is under 21 years of age at the death of the decedent.

In order to qualify for the deduction, the property passing to the orphaned child may not be a terminable interest (such as a life estate), except that the property is permitted to pass to a person other than the child's estate if the child dies before the youngest living child attains age 21. Because of the terminable interest rule, it is not presently possible to create a single trust for the benefit of a number of orphaned children as a group unless separate shares are created in the trust for each child.

Reasons for change

The committee believes that it should be possible to create a single trust for all of the decedent's orphaned children because the costs of administering separate trusts (or even separate shares of a single trust) may be prohibitive. Moreover, the committee believes sufficient flexibility should be provided to permit the trustee to accumulate income and make disproportionate distributions to orphaned children depending upon their relative needs so long as the distributions are made under certain ascertainable standards and each child will receive a pro rata portion of the trust upon termination of the trust. In addition, the committee believes that termination of the trust should not be required until the youngest child attains age 23.

Explanation of provision

The bill, as passed by the House and reported by the committee, amends the provision relating to the orphan's deduction under which property passing to a trust which meets certain requirements, called a "qualified minors' trust," qualifies for the orphan's deduction. These requirements relate to (1) the source of the trust corpus, (2) eligible beneficiaries of the trust, (3) restrictions on distributions to beneficiaries, (4) the conditions under which distributions to beneficiaries other than the orphans may be made by the trust prior to its termination, and (5) disposition of the trust property at its termination.

Under the bill, all of the initial corpus of a qualified minors' trust must be property which passes or has passed from the decedent to the trust. Thus, initial funding of the trust by the decedent's spouse or from third parties is not permitted. However, the initial corpus of the trust includes any income accumulated by the estate or trust during the administration of the estate.

All of the beneficiaries who initially have a present interest in the trust must be the decedent's children who have not attained age 21 at the date of the decedent's death. If a child of the decedent is 21 years of age or older on the date of the decedent's death, he cannot initially be a beneficiary with a present interest in the trust. (Such a person, however, may have a future interest in the trust.)

All distributions to children of the decedent must be made either pro rata to all beneficiaries of the trust or must be made under one or more specified ascertainable standards. The specified ascertainable standards permitted under the bill are standards relating to the health, education, support, or maintenance of the beneficiaries.[4] Under the bill, the ascertainable standard used by the trust may be any, or any combination, of the four specified standards.

Moreover, under the bill, the trustee may be given absolute or sole discretion to accumulate or distribute the income of the trust (subject to the rules above). Thus, under the bill, it would be permissible to grant the trustee the power to accumulate income or to distribute corpus or income (current and accumulated) to the decedent's children for their health, education, support, or maintenance.

Distribution prior to the termination of the trust to persons other than the decedent's children may be made only at the death of the

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[4] These are the same standards presently contained in sec. 2041 of the Code which are used in defining what is not a general power of appointment.

children and, in such event, that child's pro rata portion of the trust must be either (1) distributed to any person, (2) vested in a separate share in the trust for any person, or (3) remain in the trust for the benefit of the other surviving minors. For example, upon the death of a child, it would be permissible to provide that the child's pro rata portion of the trust would be distributed to the child's heirs. Likewise, it would be permissible to provide that, in the event of a child's death, his share shall remain in trust as a separate share for the benefit of his heirs. The interest of a child is not to be disqualified because it may pass to another person if the child dies before the youngest child attains age 23. Where the trust instrument does not provide for the distribution or vesting of a child's portion in a separate share of the trust upon his death, that child's portion must remain in the trust for the benefit of the remaining children of the decedent.

Upon termination of the trust, all of the then corpus and any accumulated income of the trust (other than property in separate shares) must be distributed on a pro rata basis to the children of the decedent living as of the terminating event. The trust need not terminate or vest until the youngest child of the decedent attains age 23.

Effective date

This provision is effective with respect to decedents dying after December 31, 1976.

Revenue effect

This provision will reduce budget receipts by less than $1 million per year.

28. Disclaimers (sec. 3(m) of the bill and sec. 2518 of the Code)

Present law

Under the 1976 Act, in order for a disclaimer to be valid for purposes of estate, gift and generation-skipping transfer taxes so that the person disclaiming is not treated as having transferred the property, the disclaimed interest must pass to a person other than the person making the disclaimer. To satisfy this requirement, the person making the disclaimer cannot have the authority to direct the transfer of the property to another person. It is presently unclear as to whether a disclaimer is valid for transfer tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest.

Reasons for change

The committee believes that, where the decedent spouse refuses to accept all or a portion of his or her interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest, such disclaimer should be recognized as a qualified disclaimer.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that, where a surviving spouse refuses to accept an interest in property, the disclaimer will be valid although the surviving spouse receives an income interest with respect to the property if the income

interest does not result from any direction by the surviving spouse and the disclaimer is otherwise qualified.

Effective date

This provision applies to transfers creating an interest in the person disclaiming made after December 31, 1976.

Revenue effect

This provision has no effect upon budget receipts.

29. Effective Date of Generation-Skipping Provisions (sec. 3(n) of the bill and sec. 2006(c) of the Tax Reform Act of 1976)

Present law

Under present law, as adopted under the tax Reform Act of 1976, the generation-skipping provisions apply generally to transfers made after April 30, 1976. However, exceptions apply in the case of generation-skipping transfers made pursuant to irrevocable trusts in existence on that date. An exception is also made in the case of decedents dying before January 1, 1982, if a generation-skipping transfer is made pursuant to a will (or revocable trust) which was in existence on April 30, 1976, and which was not amended at any time after that date (except in respects which do not result in the creation of, or increase in the amount of, a generation-skipping transfer).

Reasons for change

The April 30, 1976, effective date was adopted by Congress to preclude tax benefits arising from transfers made in anticipation of changes being considered by the Congress (which were ultimately adopted as part of the Tax Reform Act of 1976). However, it has come to the attention of the committee that certain taxpayers made changes in their estate plans after April 30, 1976, but on or before June 11, 1976 (the date of the Senate Finance Committee's decision to adopt new rules in the generation-skipping area), not for purposes of last minute tax planning, but because they may have been unaware of the Congressional consideration which was then taking place.

The committee believes that this result is inequitable. On the other hand, the committee also believes that after June 11, 1976, the date of the Senate Finance Committee's decision in this area, Congressional consideration of the area of generation-skipping trusts had received sufficient publicity so that individuals were (or should have been) aware after that date that Congressional action was probable.

Explanation of provision

As indicated above, the committee amendment provides that the generation-skipping transfer provisions are to apply to transfers made after June 11, 1976, rather than after April 30, 1976, as originally adopted. Therefore, the new rules apply generally to generation-skipping transfers made after June 11, 1976. Irrevocable trusts in existence on June 11, 1976, are protected under a grandfather clause except for additions to corpus after that date. Also wills and revocable trusts in existence on June 11, 1976, which were not amended after that date (except in respects which do not affect generation skipping), are protected in the case of decedents dying before January 1, 1982. Also, the 1982 cutoff date may be extended under certain circumstances where

the testator was incompetent to change the diposition of his property on June 11, 1976.

In all other respects, the committee intends that the effective date and transitional rule provisions adopted under the Tax Reform Act of 1976 are not to be affected by this amendment.

Effective date

The amendment is to take effect as of the date of enactment of the Tax Reform Act of 1976. Thus, transfers made after April 30, 1976, and before June 12, 1976, are exempt from the generation-skipping tax under the amendment.

Revenue effect

The revenue effect of this provision cannot be estimated for lack of information on the particular trusts involved.

30. Certain Powers of Independent Trustees Not Treated as a Power for Purposes of the Tax on Generation-Skipping Transfers (sec. 3(n)(2) of the bill and sec. 2613(e) of the Code)

Present law

Under present law as modified by the 1976 Act, a tax is imposed in the case of generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great grandchild of the grantor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the grantor's grandchild). In general, a generation-skipping trust is one which provides for a splitting of benefits between two or more generations which are younger than the generation of the grantor of the trust.

For a trust to be a generation-skipping trust, the trust must have "beneficiaries" who belong to two or more generations which are younger than the generation of the grantor of the trust. Under present law, a beneficiary means anyone who has a present or future interest or power in the trust.

The term "power" means any power to alter or establish the beneficial enjoyment of the corpus or income of the trust. However, there is an exception to this rule which provides that, if an individual only has a power to dispose of the corpus or the income of the trust to a beneficiary or class of beneficiaries who are lineal descendants of the grantor and who are assigned to a generation younger than the generation of the individual holding the power, this individual shall be treated as not having a power in the trust.

Reasons for change

Under present law, unless the exception described above applies, an individual trustee who has a power to spray or sprinkle income or corpus would also be a beneficiary of a trust even if he has no beneficial interest in the trust. Thus, for example, an individual trustee who has only a power to allocate income or corpus among beneficiaries of the trust could himself be a beneficiary for purposes of the generation-skipping rules if the other beneficiaries with a present interest include an individual who is not a lineal descendant of the grantor. If the in-

dividual trustee is a younger generation beneficiary of the trust (either because he is a lineal descendant of the grantor or because he is more than 12½ years younger than the grantor), the death or resignation of the trustee may give rise to a generation-skipping transfer.

This result is inappropriate in the case of an individual trustee who is independent of the grantor and the beneficiaries of the trust. This is true, at least in part, because it discriminates against such individual trustees as opposed to corporate trustees.

Explanation of provision

The bill, as passed by the House and reported by the committee, adds a new exception to the rules described above by providing that an individual trustee shall not be treated as having a power in a trust if (1) he has no interest in the trust; (2) he does not have any present or future power in the trust other than a power to allocate the corpus of the trust, or to distribute or accumulate the income to or for a beneficiary or class of beneficiaries designated in the trust instrument; and (3) he is "independent" of the grantor of the trust, as described below. Thus, the power which an independent trustee may hold without being treated as a "beneficiary" under the trust is broader than the power which will be disregarded if held by other individuals in that, in the case of an independent trustee, allocations can be made among persons other than lineal descendants of the grantor.

For purposes of these rules, an independent trustee is an individual trustee who is not "related" or "subordinate." A trustee is treated as being related or subordinate if he or she is (1) a spouse of the grantor or of any beneficiary; (2) the father, mother, lineal descendant, brother, or sister of the grantor or of any beneficiary; (3) an employee of a corporation in which the stock holdings of the grantor, the trust, and all beneficiaries of the trust are "significant" (as defined under regulations) from the viewpoint of voting control; or (4) an employee of a corporation in which the grantor or any beneficiary is an executive.

Effective date

This provision applies to any generation-skipping transfer made after June 11, 1976.

Revenue effect

This provision will have no effect on budget receipts.

31. Clarification of Rules in a Generation-Skipping Trust Where a Beneficiary Has More Than One Power or Interest (sec. 3(n)(3) of the bill and sec. 2613(b)(2) of the Code)

Present law

Under present law, a termination of the rights of a beneficiary in a generation-skipping trust may constitute an event which gives rise to the imposition of a generation-skipping tax if the beneficiary is a younger-generation beneficiary of the trust and other younger-generation beneficiaries of the trust are in younger generations more remote from the grantor than the generation of the beneficiary whose interest terminates.

Present law provides that if a younger-generation beneficiary of a trust has both an interest and a power, or more than one interest or

power, in the trust, termination with respect to each such interest or power is to be treated as occurring at the time when the last termination occurs, except in certain limited circumstances where the Treasury Department provides otherwise by regulations.

Reasons for change

The rules permitting postponement of a taxable termination where the same beneficiary holds more than one interest or power in a trust were provided to allow flexibility in the drafting of trust instruments by allowing the grantor to create powers or interests which could terminate without immediately triggering a tax. However, such a postponement rule is not appropriate where the remaining interests or powers are merely future or contingent. Where all present interests and powers of a beneficiary have terminated, this should be treated as a taxable termination, even though he may hold a future interest. While there is authority under present law to deal with the problems of future or contingent interests by regulations,[5] it appears desirable to clarify the intent of Congress in these situations.[6]

Explanation of provision

Under the bill, as passed by the House and reported by the committee, the provision clarifies present law (sec. 2613(b)(2)(B)) so that the rule which postpones termination of a beneficiary's interest or powers in a generation-skipping trust until the termination of the last such interest or power applies to "present" interest and powers, and does not allow postponement where a present interest terminates and the beneficiary's remaining interests and powers are all future or contingent.

Effective date

This provision applies to any generation-skipping transfer made after June 11, 1976.

Revenue effect

This provision will have no effect on budget receipts.

32. Alternate Valuation in Certain Cases Where There is a Taxable Termination at the Death of an Older-Generation Beneficiary (sec. 3(n)(4) of the bill and sec. 2602(d) of the Code)

Present law

Under present law, where a taxable termination occurs on the death of a younger-generation beneficiary, the assets subject to the generation-skipping tax may be valued either on the death of the younger-generation beneficiary or on the alternate valuation date with respect to his estate (sec. 2602(d)). However, if the taxable termination which would otherwise occur on the death of a younger-generation beneficiary is postponed because an older-generation beneficiary, such as the spouse of the grantor, has an interest in the generation-skipping trust,

[5] See H. Rept. 94-1380, p. 51 and n. 6.

[6] Other rules under the generation-skipping provisions generally insure that a tax will not be imposed twice with respect to transfers of the same trust in the same generation. Therefore, double taxation will not occur under this amendment, even if a beneficiary's future or contingent interest in the trust should later become a present interest which subsequently terminates.

then the assets subject to the generation-skipping tax are to be valued as of the death of the older-generation beneficiary. No alternate valuation is permitted in such a case.

Reasons for change

The rules described above can result in unintended hardship under certain circumstances. Thus, for example, where a will provides that income of a trust is to be paid to the grantor's son for life, then to the grantor's widow for life, with the remainder to the grantor's great-grandchildren, and the son predeceases the widow, the generation-skipping tax is postponed until the death of the widow and the use of the alternate valuation date is not available under those circumstances. It seems more appropriate to allow an alternate valuation to be used in these cases.

Explanation of provision

The bill, as passed by the House and reported by the committee, amends present law to provide that an alternate valuation date may be used to value the assets of a generation-skipping trust in cases where the death of an older-generation beneficiary causes a taxable termination. Thus, in such a situation, the assets may be valued either as of the date of the death of the older-generation beneficiary or on the appropriate alternate valuation date.

Effective date

This provision applies to any generation-skipping transfer made after June 11, 1976.

Revenue effect

This provision will have no effect on budget receipts.

33. Adjustment for Trust Accumulation Distribution Subject to Transfer Tax (sec. 3(o) of the bill and sec. 667 of the Code)

Present law

Under the carryover basis provisions added by the 1976 Act, an adjustment to basis is permitted for Federal estate taxes attributable to appreciation. This adjustment is designed to prevent the imposition of an income tax on the portion of the estate taxes attributable to appreciation. Similarly, when property has been sold before death but the gain is recognized by the heirs for income tax purposes, the death taxes attributable to the gain are allowable as a separate deduction in computing the taxable income of the heirs (rather than as an adjustment to the basis of the property sold). In addition, similar adjustments are also permitted with respect to the generation-skipping tax imposed under the 1976 Act.

Reasons for change

The committee believes it is appropriate to provide for an adjustment having a similar income tax effect for distributions of accumulated income by a trust which had been subject to estate tax or the generation-skipping tax.

Explanation of provision

The bill, as passed by the House and reported by the committee, provides that the tax imposed on a beneficiary with respect to an accumu-

lation distribution is to be adjusted to take into account the estate tax or generation-skipping tax attributable to the accumulated income. However, the committee bill revises the effective date to conform to the effective date changes made by the committee for the carryover basis and generation-skipping transfer provisions.

Effective date

This provision applies to the estates of decedents dying after December 31, 1979, for purposes of the estate tax and to any generation-skipping transfer made after June 11, 1976, for purposes of the generation-skipping tax.

Revenue effect

This provision has no effect upon budget receipts.

34. Reliance by an Executor on Information Furnished by the IRS Concerning the Decedent's Taxable Gifts Made After 1976 (sec. 3(p) of the bill and sec. 2204 of the Code)

Present law

The 1976 Act imposed a single unified progressive rate schedule on the basis of the cumulative lifetime and deathtime transfers. Under this system, the estate tax is dependent upon the lifetime transfers of the decedent. In addition, an executor must file an estate tax return where the gross estate exceeds $120,000 (increasing to $175,000 in the case of decedents dying after 1980) reduced by the taxable gifts made after 1976.

Thus, in order to compute the amount of estate tax for which the estate is liable, the executor must know the total amount of taxable gifts which had been made by the decedent after 1976. Although an executor can obtain copies of any tax return of the decedent, there is nothing in present law which relieves an executor from personal liability for any estate tax because of incorrect information contained in those returns or for gifts for which returns were not filed.

Reasons for change

The committee understands that it is often difficult for executors to determine to whom the decedent had made taxable transfers during his lifetime. Because of this problem, your committee believes that the executor should be permitted to rely upon the gift tax returns furnished to him by the IRS where his reliance is in good faith.

Explanation of provision

The bill, as passed by the House and reported by the committee, relieves the executor from liability for additional estate taxes attributable to gifts not shown on a return if the executor, in good faith, relied upon information furnished by the IRS concerning the taxable gifts made by the decedent after 1976. However, the executor is not relieved from liability for gifts made within three years of the decedent's death.

Effective date

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

Revenue effect

This amendment will have no effect on budget receipts.

35. Amendment of Governing Instruments to Meet Requirements for Gifts of Split Interest to Charity (sec. 3(q) of the bill and sec. 2055(e) of the Code

Present law

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part non-charitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Many persons have created instruments that do not comply with these new requirements. As a result, Congress provided, as early as 1974, that the governing instruments of trusts could be amended to meet the new rules within certain time limitations.[7] However, it provided this relief only in the case of the charitable deduction for estate tax purposes and only for remainder interests passing to charity. No relief was provided for the charitable deduction for income or gift tax purposes or for "income" interests passing to charity for income, gift or estate tax purposes.

Reasons for change

The committee believes that relief similar to that previously provided for remainder interests passing to charity for estate tax purposes should be permitted for lifetime transfers in trust of both income and remainder interests to charity for income and gift tax purposes and for income interests to charity for estate tax purposes.

Explanation of provision

The bill, as passed by the House and reported by the committee, permits amendment of the governing instruments of charitable lead trusts to be effective for purposes of the income, gift, and estate tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977. Similarly, the bill permits amendment of the governing instruments of charitable remainder trusts to be effective for purposes of the income and gift tax charitable deductions if the amendment is made (or judicial proceedings are begun) by December 31, 1977.

Effective date

This provison shall apply if a governing instrument is amended (or judicial procedings are begun) on or before December 31, 1977.

Revenue effect

This provision will reduce budget receipts in fiscal 1978 by $12 million and will have no effect upon budget receipts thereafter.

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[7] The latest extension was granted in the 1976 Act. The Act extended the period until December 31, 1977, during which amendments of trusts are permitted in order to qualify the trust for the charitable estate tax deduction as a charitable remainder trust.

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36. Public Indexing of Federal Tax Liens (sec. 3(r) of the bill and sec. 6323 of the Code)

Present law

Generally, a Federal tax lien takes priority (with certain relatively limited exceptions) over interests in the property subject to the lien which are held by purchasers, holders of a security interest, mechanic's lienors and judgment lien creditors if notice of the tax lien has been appropriately filed before such interests are acquired. The 1976 Act provided that a notice of a lien is not to be treated as meeting the filing requirements unless a public index of the lien is maintained at the district Internal Revenue Service office in which the property subject to the lien is situated. For this purpose, an index of liens affecting real property would be maintained in the district office for the area in which the real property is physically located. In the case of liens affecting personal property, the nidex would be maintained in the district office for the area in which the residence of the taxpayer is located at the time the notice of lien is filed.

Reasons for change

The requirement for public indexing of tax liens at the appropriate district Internal Revenue Service office as resulted in the imposition of a significant burden in searching titles in connection with real estate sales. A person searching a title has to check the records at the local courthouse and also at the district Internal Revenue Service office for Federal tax liens. In many instances, the district office will be located some considerable distance away. The Federal index will often duplicate an index already maintained at the State or local office.

For these reasons, the committee believes that the Federal indexing requirement should be repealed and that a new indexing requirement should apply under applicable local law with respect to the indexing by the State or local office where notices of tax liens are filed rather than having the Internal Revenue Service maintain an index.

Explanation of the provision

The bill, as passed by the House and reported by the committee, repeals the Federal indexing requirement. A new indexing requirement for the Federal tax lien would apply at the local level where the notices of tax lien are usually filed and would apply only with respect to real estate. The exclusion of personal property from the indexing requirement is consistent with the perfection-by-filing approach taken under the secured transactions article of the Uniform Commercial Code, which has been adopted by almost all States with respect to security interests in personal property.

In the case of real property, the new indexing requirement is to apply only if two conditions are met. First, State law must require public indexing of a deed to be valid against a purchaser of the property who does not have actual notice or knowledge. Thus, the Federal tax lien is not to be singled out for an indexing requirement under the applicable State law when other interests are not required to be indexed for protection against subsequent purchasers. It is expected that Internal Revenue Service will issue rulings to advise the public as to its understanding of which States require indexing for protection against subsequent purchasers and which do not.

Second, the appropriate office where notices of tax lien are filed must have an adequate system for indexing of Federal tax liens. For this purpose, the system is not to be considered as adequate unless it is set up and maintained in such a way that a reasonable inspection of the index will reveal the existence of the tax lien. It would not be necessary to maintain both a tract index and an alphabetical taxpayer index if either one would satisfy this condition. However, the index could be considered inadequate if the local clerk responsible for indexing consistently fails to index within a reasonable time after notices of tax lien have been filed by the Service. If the indexing requirement would apply but for the indexing system subsequently becoming inadequate, it is expected that the Service will make a public announcement that it does not consider the system adequate so that title searchers will be on notice as to this position. However, the Service is expected to allow a reasonable period for a recording clerk to attempt to correct any deficiencies in a system before finally determining that the system is considered inadequate.

Where these conditions are satisfied, the priority of a tax lien against purchasers and other creditors will be determined by the reference to the time of indexing rather than the time of filing of the notice of tax lien. Purchasers and creditors, who acquire their interests in the property subject to a tax lien before the notice of tax lien has been indexed, will be protected against a previously filed tax lien.

Effective date

The amendments are to apply to liens, other security interests, and other interests in real property acquired after the date of the enactment of the bill. If, after the date of enactment, there is a change affecting the application of the indexing requirement (such as a change in State law relating to the necessity of indexing for protection against subsequent purchasers), the change is to apply only with respect to liens, other security interests, and other interests in real property acquired after the date of such change.

Revenue effect

These provisions will have no significant revenue effect.

37. Clerical Amendments (sec. 3(s) of the bill and secs. 1016, 2051, 6324B and 6698 of the Code)

Section 3(s) of the bill reflects a number of clerical amendments to the estate and gift tax provisions:

Amendment of sec. 6698. The 1976 Act added two new section 6694's. The section 6694 relating to failure to file information with respect to carryover basis property is redesignated as section 6698.

Amendment of sec. 2051. This provision deletes a reference to the estate tax exemption which was repealed by the 1976 Act.

Amendment of sec. 1016. The paragraph added by the 1976 Act as paragraph (23) of section 1016(a) is redesignated as paragraph (21).

Amendment of sec. 6324B. This provision corrects a reference in section 6324B to conform the term "qualified real property" to its definition in section 2032A.

C. OTHER CLERICAL CORRECTIONS, CROSS REFERENCES, ETC.

(Sec. 4 of the bill and various sections of the Code)

Section 4 of the bill reflects a number of clerical corrections and cross reference changes to the Tax Reform Act of 1976. Many of these changes are necessitated by the changes made by Title XIX of the 1976 Act, popularly referred to as the "deadwood" provisions. These provisions deleted a number of little-used provisions and made many simplifying changes to the Code.

The following is a section-by-section explanation of the clerical and cross reference changes.

1. Cross References Relating to the Investment Credit (sec. 4(a) of the bill and secs. 46 and 48 of the Code)

a. Amendment of section 46(f)(8).—The first sentence of section 46(f)(8) is amended to change the cross reference to subsection (a)(7)(D) of section 38 instead of subsection (a)(6)(D).

b. Amendment of section 46(g)(5).—The cross reference in section 46(g)(5) is corrected to the Merchant Marine Act, 1936 instead of the Merchant Marine Act, 1970.

c. Amendment of section 48(d)(1)(B).—The cross reference in section 48(d)(1)(B) is corrected to be section 46(a)(6) instead of section 46(a)(5).

d. Amendment of section 48(d)(4)(D).—The cross reference in section 48(d)(4)(D) is corrected to be section 57(c)(1)(B) instead of section 57(c)(2).

2. Prepaid Legal Services (sec. 4(b) of the bill, section 2134(e) of the Tax Reform Act of 1976, and sec. 501(c)(20) of the Code)

a. The reference in section 2134(e) of the Tax Reform Act of 1976 is corrected to be section 120(d)(7) of the Code instead of section 120(d)(6).

b. A clerical change is made in section 501(c)(20) of the Code to delete the internal reference to "section 501(c)(20)" and instead refer simply to "this paragraph."

3. Corrections Relating to Individual Retirement Account Provisions (sec. 4(c) of the bill and secs. 219, 220 and 408 of the Code)

a. Amendment of section 219(c)(4).—The reference in section 219(c)(4) is corrected to be subsection (b)(2)(A)(iv) instead of subsection (b)(3)(A)(iv).

b. Amendment of section 220(b)(1)(A).—This corrects a clerical error in section 220(b)(1)(A) of the Code.

c. Amendment of section 220(b)(4).—This clarifies the reference to "any payment" by indicating that it refers to "any payment described in subsection (a)" of section 220 of the Code.

d. Amendment of section 408(d)(4).—A clerical correction is made to section 1501(b)(5) of the Tax Reform Act of 1976 so that each reference in Code section 408(d)(4) to section 219 is also followed by "or 220" as was intended in the drafting of the Act.

4. Accrual Accounting for Farm Corporations (sec. 4(d) of the bill and sec. 447 (a) and (g)(2) of the Code)

A correction is made to sections 447 (a) and (g)(2) of the Code to refer to "preproductive period expenses" instead of to "preproductive expenses" in order to conform these references to the exact term as defined in section 447(b).

5. Renumbering of Section 911(c) (sec. 4(e) of the bill and sec. 911(c) of the Code)

A clerical change is made by renumbering section 911(c)(8) as section 911(c)(7).

6. Transition Rule for Private Foundations (sec. 4(f) of the bill and sec. 101(l)(2)(F) of the Tax Reform Act of 1969)

A modification of the 1969 Act's transitional rule for sales of property by private foundations was made by section 1301(a)(3) of the Tax Reform Act of 1976. This provision of the bill corrects a clerical error made in that modification by inserting a comma in lieu of the period at the end of clause (i) of section 101(l)(2)(F) of the 1969 Act, as amended by the 1976 Act.

7. Lobbying by Public Charities (sec. 4(g) of the bill and secs. 501, 4911, 6313, and 6405 of the Code)

The bill makes a clerical change in the heading of the table setting forth the lobbying nontaxable amounts of public charities to reflect that the proper base for measuring such amounts is "exempt purpose expenditures." The bill also makes technical amendments to section 501 of the Code (relating to exempt organizations) to correct clerical errors in the coordination of subsection designations by the Tax Reform Act of 1976 and Public Law 94–568.

8. Amendments to Foreign Tax Provisions (sec. 4(h) of the bill and sec. 1035 of the Tax Reform Act of 1976 and sec. 999 of the Code)

a. A clerical change is made to section 1035(c)(2) of the Tax Reform Act of 1976 to make it clear that the phrase "oil and gas extraction income" has the same meaning for purposes of that section as the meaning in section 907(c) of the Code.

b. The cross reference in section 999(c)(1) of the Code is corrected to be 995(b)(1)(F)(ii) rather than section 995(b)(3).

c. The cross reference in section 999(c)(2) of the Code is corrected to be section 995(b)(1)(F)(ii) instead of section 999(b)(1)(D)(ii).

9. Amendments to DISC Provisions (sec. 4(i) of the bill and secs. 995 and 996 of the Code and sec. 1101 of the Tax Reform Act of 1976)

a. The reference in section 995(b)(1) of the Code to "gross income (taxable income in the case of subparagraph (D))" is changed to refer simply to income. In addition, the reference to subparagraph (E) is corrected to be a reference to subparagraph (G).

b. The cross reference in section 996(a)(2) of the Code is corrected to be section 995(b)(1)(G) instead of section 995(b)(1)(E).

c. The cross reference in section 1101(g)(5) of the Tax Reform Act is corrected to be section 995(e)(3) instead of section 993(e)(3).

10. Clerical Amendments Relating to "Deadwood" Provisions (sec. 4(j) of the bill)

a. Tax-Exempt Governmental Obligations (sec. 4(j)(1) of the bill and sec. 103 of the Code)

This paragraph provides a number of amendments to section 103 of the Code to conform to amendments made to section 103 by sections 1901(a)(17) and 2105 of the Tax Reform Act of 1976.

b. Amendments Relating to Section 311(d)(2) (sec. 4(j)(2) of the bill and sec. 311(d)(2) of the Code)

A clerical change is made to section 311(d)(2) by redesignating subparagraph (H) as subparagraph (G).

The cross references in section 2(b) of the Bank Holding Company Tax Act of 1977 to subparagraph (F) and subparagraph (b) are corrected to subparagraph (E) and subparagraph (F), respectively.

c. Installment Method of Accounting (sec. 4(j)(3) of the bill and sec. 453 of the Code)

This provision eliminates the effects of a deadwood change made to section 453 of the Code by section 1901(a)(66)(A) of the Tax Reform Act of 1976. The language in section 453 of the Code which was amended by the Tax Reform Act is considered obsolete and therefore can be deleted in its entirety.

d. Definition of Life Insurance Company (sec. 4(j)(4) of the bill and sec. 801 of the Code)

This amendment makes conforming changes to reflect the amendment of section 805 of the Code (relating to pension plan reserves) made by section 1901(a)(97)(C) of the 1976 Act. The Act deleted from section 805 an obsolete transitional rule and renumbered the remaining provisions, but failed to make a conforming change in section 801(g) of the Code (relating to contracts with reserves based on segregated asset accounts). Accordingly, the bill deletes from section 801(g)(1)(B)(ii) and (7) the references to "subparagraph (A), (B), (C), (D), or (E) of section 805(d)(1)" and substitutes a reference to paragraph (1), (2), (3), (4), or (5) of section 805(d).

e. Amendment of section 1033(a)(2)(A) (sec. 4(j)(5) of the bill and sec. 1033(a)(2)(A) of the Code)

The cross reference in section 1033(a)(2)(A) is corrected to section 1033(b) instead of section 1033(c).

f. Amendment of section 1375(a)(2) (sec. 4(j)(6) of the bill and sec. 1375(a)(2) of the Code)

Section 1375(a)(2) is corrected by changing the term "such excess" to "such gain".

g. Definitions Relating to the Tax on Self-Employment Income (sec. 4(j)(7) of the bill and sec. 1402 of the Code)

This provision makes two clerical amendments to section 1402 of the Code to conform to the amendment made to section 1402 by section 1901(a)(155)(B) of the Tax Reform Act of 1976.

h. Computing the Amount of the Investment Credit (sec. 4(j)(8) of the bill and sec. 46 of the Code)

This provision amends section 1901(b)(1)(C) of the Tax Reform Act of 1976 to conform to an amendment made by section 802(a)(1) of that Act Section 1901(b)(1)(C) of the Act made an amendment to section 46(a)(3) of the Code, but that amendment should have been made to section 46(a)(4) of the Code, inasmuch as section 46(a)(3) was redesigned as section 46(a)(4) by section 802(a)(1) of the Act. This provision of the bill amends section 1901(b)(1)(C) of the Act to make it refer, as it should, to section 46(a)(4) of the Code.

i. Cross Reference (sec. 4(j)(9) of the bill and secs. 6504 and 6515 of the Code)

This provision corrects a typographical error made in section 1901(b)(37)(D) of the Tax Reform Act of 1976.

j. Special Tax Rules Affecting Territories (sec. 4(j)(10) of the bill and sec. 37 of the Code)

This provision repeals section 1901(c)(1) of the Tax Reform Act of 1976. That provision of the Tax Reform Act, which amended section 37(f) of the Code by eliminating an obsolete reference to a "Territory," was made superfluous by a substantive amendment made to that same section of the Code by section 503(a) of the Tax Reform Act.

k. Effective Dates of Tax Reform Estate and Gift Tax Amendments (sec. 4(j)(11) of the bill and sec. 1902(c) of the Tax Reform Act of 1976)

This provision corrects a group of clerical errors in section 1902(c) (providing effective dates for the "Deadwood" estate and gift tax amendments) of the Tax Reform Act of 1976. These errors resulted because the effective date provisions for the estate and gift tax amendments of the Code made by Title XIX of the Tax Reform Act (the so-called Deadwood amendments) were not conformed to amendments to the same estate and gift tax sections of the Code made by other titles of the Act.

l. Tax on Excess Retirement Plan Contributions (sec. 4(j)(12) of the bill and sec. 4973(a) of the Code)

This deletion is necessary because the Tax Reform Act erroneously gave section 1904(a)(22)(A) of the Act, which provided a technical amendment to section 4973(a) of the Code, an effective date that was subsequent to the effective date of section 1501(b)(8) of the Act, which made a substantive change to that same section of the Code. As a result, except for this provision of the bill, the technical correction language of section 1904(a)(22)(A) of the Act would replace the more complete amendment made to section 4973(a) of the Code by section 1501(b)(8) of the Act. This provision of the bill advances the effective date of the language of section 1904(a)(22)(A) of the Act thereby leaving in place the amendment made by section 1501(b)(8) of the Act.

m. Social Security Act Amendments (sec. 4(j)(13) of the bill and secs. 202, 205, 210, and 211 of the Social Security Act)

This provision makes a number of amendments to sections of the Social Security Act to conform to several amendments made to the Internal Revenue Code by the Tax Reform Act of 1976.

11. Capital Loss Carryover (sec. 4(k) of the bill and sec. 1212 of the Code)

This provision corrects the phrase "exceeding the loss year" to read "succeeding the loss year."

12. Aircraft Museums (sec. 4(1) of the bill and secs. 4041, 6427, and 7609 of the Code)

This amendment makes several clerical and conforming changes arising under P.L. 94–530, which provides an exemption from the fuel and aircraft use excise taxes for certain aircraft museums. A clerical change is made to insert an omitted word in section 4041(h) (2), added by P.L. 94–530. In addition, conforming changes are made to correct cross references in section 4041 and other Code provisions, and to conform the aircraft museum amendments with changes made by the deadwood provisions of the Tax Reform Act of 1976.

13. Inspection of Returns by Congress (sec. 4(m) of the bill and sec. 6104 of the Code)

This provision corrects a cross reference in section 6104 to section 6103.

14. Limitation on Assessment and Collection (sec. 4(n) of the bill and sec. 6501 of the Code)

This provision corrects a reference in section 6501 to section 6213 (b)(3).

15. Conforming Amendment Regarding Definition of Taxable Income (sec. 4(o) of the bill and sec. 443(b) of the Code)

Section 443(b) is amended to conform that section to the amendment to the redefinition of the term "taxable income" by the Tax Simplification and Reduction Act of 1977.

16. Conforming Amendment to Section 172 (sec. 4(p) of the bill and secs. 172(b)(3)(A), 6501(h) and 6511(d)(2)(A) of the Code)

Section 172(b)(3)(A) is amended to conform that section to the repeal of section 317 of the Trade Expansion Act of 1962.

17. Tax-Exempt Bonds for Student Loans (sec. 4(q) of the bill and sec. 103(c) of the Code)

The reference in section 103(c)(5) of the Code relates to the Emergency Insured Student Loan Act of 1969, which Act was repealed on October 12, 1976, and succeeded by similar provisions contained in the Education Amendments of 1976 (P.L. 94–482). This reference is deleted and replaced by the appropriate reference to the statute as amended by the Education Amendments of 1976.

IV. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 6715, AS AMENDED

Revenue Cost

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 6715 as reported by the committee. The committee estimates that the changes in fiscal year budget receipts made by this bill, as amended, for fiscal years 1979–83 are as follows:

[In millions of dollars]

Provision	Fiscal year—				
	1979	1980	1981	1982	1983
"Fresh" start for sec. 306 stock			(1)	−5	−7
Redemption of preferred stock to pay death taxes			(1)	−2	−3
Postpone effective date of 1976 act carryover basis	−36	−93	−162	−133	−110
Total	−36	−93	−162	−140	−120

[1] Less than $1,000,000.

In addition, the bill as reported, has a number of other provisions which involve minor revenue effects which are not given specific dollar estimates in the text. Further, the bill as reported will have the following effect on fiscal year 1978 budget receipts (millions):

(a) Transitional rule for recapture of possessions source losses	$−2
(b) Foreign tax credit effective date for production-sharing contracts	−5
(c) Recapture of depreciation on player contracts	−1
(d) Amendment of governing instruments to meet requirements for gifts of split interest to charity	−12
Fiscal year 1978	−20

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 6715, as amended by the committee, was ordered reported by a voice vote.

V. REGULATORY IMPACT OF THE BILL AS REPORTED AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to Rule XXIX of the Standing Rules of the Senate, as amended by S. Res. 4 (February 4, 1977), the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of H.R. 6715, as reported by the committee.

A. *Numbers of individuals and businesses who would be regulated.*—The provisions of this bill are primarily to make technical, conforming, clarifying and clerical amendments in order to make corrections or clarifying changes in certain income and estate and gift tax provisions of the Tax Reform Act of 1976.

B. *Economic impact of regulation on individuals, consumers, and businesses affected.*—The provisions will make it easier for affected taxpayers to understand and comply with the tax code changes made by the Tax Reform Act of 1976. The postponement of the 1976 Act carryover basis provision will allow present law provisions and practice to continue for 3 additional years.

C. *Impact on personal privacy.*—The bill makes negligible changes in those provisions of Federal law relating to the personal privacy of taxpayers.

D. *Determination of the amount of paperwork.*—The bill will involve little, if any, additional paperwork for taxpayers. It will reduce the uncertainties and paperwork for some taxpayer affected by the tax law changes made by the Tax Reform Act of 1976, and will significantly reduce the potential paperwork and compliance costs involved for many of the estates that would otherwise be affected by the 1976 Act carryover basis changes during the 3-year postponement period.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as shown in part IV of this report) and agrees with the methodology used and the resulting dollar estimates for those items.

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill involves no new budget authority.

Allocations of Budget Authority

The committee states that since H.R. 6715 involves no new budget authority, there are no budget authority allocations.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expeditures, and after consultation with the Director of the Congressional Budget Office, the committee makes the following statement. The changes made by this bill involve new tax expenditures of $7 million for fiscal year 1978, $140 million for fiscal year 1982, and $120 million for fiscal year 1983. The major portion of the new tax expenditures for fiscal years 1982 and 1983 are due to the postponement of the effective date of the "carryover basis" provisions. In addition, the bill has a number of other income tax provisions which may involve tax expenditures; however, since some provisions have no specific dollar estimates, it is impractical to report their effect upon total revenues or total tax expenditures.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

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