Calendar No. 1168

96TH CONGRESS *2d Session*	SENATE	REPORT No. 96-1036

MISCELLANEOUS REVENUE ACT OF 1980

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 7956

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Ordered to printed

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

REPORT

[To accompany H.R. 7956]

The Committee on Finance, to which was referred the act (H.R. 7956) to make various changes in the tax laws, having considered the same, reports favorably thereon with amendments and recommends that the act as amended do pass.

The amendments are shown in the text of the bill in italic.

House bill.—H.R. 7956, as it passed the House, contained provisions relating to (1) the treatment of certain community income for spouses living apart, (2) amortization of business startup costs, (3) charitable deductions for certain contributions of real property for conservation purposes, (4) investment tax credit for rehabilitated buildings leased to tax-exempt organizations or governmental units, (5) the revision of source rules for income from certain leased aircraft, vessels, and spacecraft, (6) tax rates applicable to nonexempt income of homeowners associations, (7) the tax treatment of certain income of mutual or cooperative telephone and electric companies, (8) the refund of taxes on certain State police officer subsistence allowances, (9) the clarification of the limitation on deductibility of certain entertainment facility expenses includible in income of the recipient, (10) prevention of abuse of certain employee benefit requirements, (11) certain provisions relating to employee stock ownership and cafeteria plans, (12) the election of estate tax alternate valuation, and (13) a two-year extension of time to amend governing instruments of charitable split-interest trusts.

Committee bill.—The committee bill retains most of the provisions of the House bill but (1) postpones for one year (to taxable years beginning after 1980) the provisions relating to the treatment of certain community income for spouses living apart, (2) deletes the provisions relating to contributions of real property for conservation purposes (similar provisions are contained in H.R. 6975, as it passed the Senate), (3) deletes the provision relating to the investment tax credit for rehabilitated buildings leased to tax-exempt organizations or governmental units, (4) makes the provision relating to the participation of a subsidiary corporation in a tax credit employee stock ownership plan effective as if that provision had been included in the Revenue Act of 1978 (rather than for taxable years beginning after December 31, 1980), (5) extends for three years (through 1981) the time for conforming governing instruments of charitable split-interest trusts, (6) adds a provision relating to the investment tax credit for martime satellites (section 7 of H.R. 4746, as it passed the House), (7) adds a provision relating to the treatment of debt-financed real estate investments by qualified employees' trusts, and (8) adds a provision to repeal the withholding tax on pensions paid to nonresident aliens (previously reported by the committee as section 407 of H.R. 1212 and H.R. 2492).

I. SUMMARY

Section 101—Treatment of certain community income for spouses living apart

Under present law, income considered community property under State law is taxed in equal shares to a husband and wife. Generally, under this provision, community property laws are to be disregarded for income tax purposes when the spouses have lived apart for the entire year and no portion of the income earned by one spouse has been transferred to the other spouse. The provision is intended to provide relief for abandoned spouses who are presently taxed on a portion of the income earned by the other spouse.

Section 102—Amortization of business startup costs

Under present law, costs incurred prior to the commencement of a business normally are nondeductible because they are not incurred in carrying on a trade or business. These startup or preopening costs must be capitalized and often cannot be depreciated or amortized because no ascertainable useful life can be established for these costs. However, the capitalized costs may be recovered for purposes of measuring gain or loss upon the disposition or cessation of the business.

Under this provision, qualifying business startup or investigatory expenses may, at the election of the taxpayer, be amortized over a period of not less than 60 months.

Section 103—Revision of source rules of income from certain leased aircraft, vessels, and spacecraft

This provision would revise the rules for determining the source of income from the lease of certain vessels, aircraft, and spacecraft. The income or loss would generally be treated as from U.S. sources if the craft qualifies (or would qualify except for governmental use) for the investment tax credit, is leased to a U.S. person, and is U.S. manufactured. This rule would treat income as from U.S. sources in later periods even if the craft is then leased to a foreign person.

Section 104—Tax rates applicable to nonexempt income of homeowners associations

Under present law, a qualified homeowners association is not taxed on its exempt function income. Other income, less certain deductions, is taxed at the highest corporate rate of 46 percent except for long-term capital gains, which are taxed at a rate of 28 percent. Under this provision of the bill, all income of a homeowners association (other than exempt function income) will be taxed at a rate of 30 percent.

Section 105—Tax treatment of certain income of mutual or cooperative telephone and electric companies

This section of the bill provides that, in determining whether a mutual or cooperative telephone or electric company meets the 85-percent member-income requirement for tax exemption (under Code sec. 501(c)(12)), any income from rental of poles used in the cooperative's exempt activities and, in the case of a mutual or cooperative telephone company, income from display listings in a directory) is to be disregarded. The section also provides that income from the rental of such poles by mutual or cooperative telephone and electric companies is not subject to the tax on unrelated business taxable income.

Section 106—Refund of taxes on certain State police officer subsistence allowances

Under present law, cash meal allowances received by State police officers are includible in gross income. However, Public Law 95-427 provided that certain cash meal allowances received by State police officers during the period after 1969 and before 1977 are not includible in income to the extent the allowances *were not reported* by the officers.

The provision will allow a refund or credit of taxes paid by a State police officer with respect to cash meal allowances which *were reported* in gross income in returns filed by the officer for calendar years 1974, 1975, and 1976.

Section 107—Clarification of limitation on deductibility of certain entertainment facility expenses includible in income of recipient

Under this provision, the general rule for the disallowance of deductions for entertainment, amusement, or recreation expenses (Code sec. 274(a)) does not apply to expenses which are includible in the gross income of the recipient of the entertainment, amusement, or recreation as compensation for services or as a prize or award under Code section 74. This provision will not apply if the taxpayer fails to include the amount in any information return (Form 1099) which is required to be filed with the Internal Revenue Service (or would be required except that the amount is less than $600).

Section 108—Investment tax credit for certain property used in maritime satellite communications

Under present law, the investment credit is not generally available for property used outside the United States or for property used by an international organization. Under the Revenue Act of 1971, these limitations were made inapplicable to interests of United States persons in communications satellites used by the International Telecommunications Satellite Organization (INTELSAT). This permitted the Communications Satellite Corporation (COMSAT), the governmentally designated United States participant in INTELSAT, to obtain the credit on its share of qualifying investments made by the INTELSAT joint venture.

This section of the bill would similarly make the credit available for interests of United States persons in communications satellites used by the International Maritime Satellite Organization (INMARSAT), an international organization established to develop and operate a global maritime satellite telecommunications system.

Section 109—Exemption from unrelated business income tax for certain real estate investments of qualified employees' trusts

Under present law, a qualified employee trust does not pay tax on its investment income, unless the income is from property that was debt-financed. Income from such property is termed "unrelated business income" in the proportion that the property is debt-financed and is taxed.

The bill provides that, with certain exceptions, debt incurred by a tax-exempt employee trust with respect to real estate investments will not be considered acquisition indebtedness (and, consequently, none of the income from such investments would be subject to the tax on unrelated business income).

Debt does not qualify for this exception, where it is incurred with respect to real property if—

(1) the purchase price is not a fixed amount determined as of the date of acquisition,

(2) the purchase price (or the amount or timing of any payment is dependent, in whole or in part, upon the future revenues, income, or profits derived from the property,

(3) the property is leased to the transferor (or to a party related to the transferor),

(4) the property is acquired from, or leased to, certain persons who are disqualified persons with respect to the trust, or

(5) the debt is nonrecourse debt owed to the transferor (or a related party) which either

(a) is subordinate to any other indebtedness secured by the property, or

(b) bears a rate of interest significantly less than that which would apply if the financing had been obtained from a third party.

Sections 201-206—Provisions relating to employee stock ownership and cafeteria plans

1. Cash distribution option and put option for stock bonus plans (sec. 201 of the bill)

This provision will permit a tax-qualified stock bonus plan to distribute cash to a participant entitled to a distribution, subject to the participant's right to demand that benefits be distributed in the form of employer stock. If a stock bonus plan provides for cash distributions and if stock which is distributed is not readily tradable on an established market, the participant must have the right to require the employer to repurchase the stock.

2. Special limitation for tax credit employee stock ownership plans and employee stock ownership plans (sec. 202 of the bill)

Under this provision, the increase in the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan (provided certain requirements are met with respect to allocations under the plan) will be the lesser of (1) the usual dollar limitation on annual additions to a participant's account, or (2) the amount of employer securities (or cash used to acquire such securities) contributed to the plan.

3. *Valuation of employer securities in tax credit employee stock ownership plans (sec. 203 of the bill)*

Under this provision, the value of employer securities listed on a national exchange contributed to a tax credit employee stock ownership plan will be the average of the closing prices of such securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan.

4. *Participation of subsidiary corporation in a tax credit employee stock ownership plan (sec. 204 of the bill)*

Under this provision, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute employer securities of the parent corporation to its tax credit employee stock ownership plan. In addition, parent stock could be contributed by 80-percent owned lower-tier subsidiaries in this chain.

5. *Retirement savings by tax credit employee stock ownership plan participants (sec. 205 of the bill)*

Under this provision, if employees are permitted to elect out of a tax credit employee stock ownership plan for the purpose of establishing IRAs, the tax credit employee stock ownership plan does not fail to meet the minimum coverage requirements of the Code if the plan benefits at least 50 percent of all employees (excluding employees who have not satisfied the minimum age and service requirements or who are otherwise permitted to be excluded), and if the total allocations under the tax credit employee stock ownership plan are equal to no more than two percent of the compensation of participating employees.

6. *Cafeteria plans permitted to provide deferred compensation under rules applicable to cash or deferred profit-sharing and stock bonus plans (sec. 206 of the bill)*

Under this provision, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

Section 207—Elimination of withholding tax on pensions paid to certain nonresident aliens

Under present law, a nonresident alien is not subject to U.S. tax on compensation for services performed outside the United States. A nonresident alien is, however, generally subject to a tax of 30 percent on investment income (interest, dividends, etc.) from U.S. sources. If a nonresident alien receives a pension in the form of an annuity from a qualified trust or under a qualified annuity plan, it would generally be subject to the 30-percent withholding tax on the portion of the annuity attributable to U.S. source investment income earned on the contributions while they were held by the trust, unless a statutory or treaty exemption applies. Currently, there is a statutory exemption from tax on a pension paid to a nonresident alien for services performed outside the United States, if, at the time the annuity payments begin, 90 percent or more of the employees for whom contributions or benefits are provided by the plan are citizens or residents of the United States. Also, a number of U.S. tax treaties provide reciprocally that pensions and annuities received by a resident of one country from sources in the other are taxable only by the country of residence.

The committee amendment would expand the statutory exemption from tax for pensions and annuities by making it available to an individual if (1) the recipient's country of residence grants a substantially equivalent exclusion to citizens and residents of the United States or (2) the recipient's country of residence is a "beneficiary developing country" under section 502 of the Trade Act of 1974. This provision would apply to amounts received after July 1, 1979.

Section 301—Election of estate tax alternate valuation

Under present law, an executor may elect to value assets for estate tax purposes as of the date of the decedent's death or the alternate valuation date which is generally six months after the decedent's death. Alternate valuation must be elected on an estate tax return that is timely filed.

This provision will permit an executor to elect alternate valuation on a timely filed estate tax return or, if no estate tax return is timely filed, on the first estate tax return filed.

Section 302—Extension of time to amend governing instruments of charitable split-interest trusts

The Tax Reform Act of 1969 imposed new requirements which must be satisfied by charitable lead and remainder trusts in order for an income, gift, or estate tax deduction to be allowed for the transfer of an income interest or a remainder interest to charity. However, certain exceptions were provided in the case of wills executed, or property transferred in trust, on or before October 9, 1969, in order to allow a reasonable period of time to take the new rules into account.

The provision extends for three years, until December 31, 1981, the time to amend, or commence judicial proceedings to amend, instruments of both charitable lead trusts or charitable remainder trusts which were executed before December 31, 1977, in order to conform such instruments to the 1969 Act requirements for a charitable deduction to be allowed for income, gift, or estate tax purposes.

II. EXPLANATION OF THE BILL

A. Treatment of Certain Community Income for Spouses Living Apart (sec. 101 of the bill and new sec. 66 of the Code)

Present law

Under present income tax laws, income considered community property under State law generally is taxed in equal shares to a husband and wife. Consequently, if a husband and wife file separate returns, each is usually required to report one-half of the income considered community property.

Reasons for change

Under present law, an abandoned spouse may be liable for Federal income tax on one-half of the community income earned by the other spouse even though the abandoned spouse has not actually received or benefited from any of the income. The committee believes that in these circumstances a spouse should not be taxed on community income earned or received by the other spouse.

Explanation of provision

If certain requirements are met, State community property laws would be disregarded with respect to certain types of income for Federal income tax purposes. To qualify, a couple must be married at some time during the calendar year, but live apart during the entire calendar year and not file a joint return with respect to a taxable year beginning or ending in the calendar year. In addition, one or both of the spouses must have earned income for the calendar year that is community income, and no portion of that earned income must have been transferred directly or indirectly between the spouses during the calendar year. For purposes of the latter income transfer test, the committee intends that transfers of *de minimis* amounts or value are not to be taken into account. It is anticipated that definitive guidance concerning these amounts will be prescribed in Treasury regulations, revenue rulings, or revenue procedures, and periodically revised as circumstances may warrant. Further, a transfer or payment to, or for the benefit of, the couple's dependent child is not to be treated as an indirect transfer to an abandoned spouse solely because the payment or transfer satisfies an obligation of support imposed on the abandoned spouse.

If the requirements are met, any community income of the spouses for the calendar year is allocated in accordance with Code section 879(a). Under that provision, earned income (other than trade or business income and a partner's distributive share of partnership income) is, for tax purposes, the income of the spouse who rendered the personal services. In the case of income derived from a trade or business (other than that carried on by a partnership), the income is treated as the husband's income unless the wife exercises substantially all of the management and control of the trade or business. In the case of trade or business income of a partnership, the income is taxed to the spouse who has a distributive share of the partnership profits.

Effective date

The provision applies to calendar years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will have a negligible effect on budget receipts.

B. Amortization of Business Startup Costs (sec. 102 of the bill and new sec. 195 of the Code)

Present law

In general

Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenditures made in acquiring or creating an asset which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

Certain business organizational expenses for the formation of a corporation or partnership may be treated as deferred expenses, on an elective basis, and amortized over a period of not less than 60 months (Code secs. 248 and 709). Expenditures eligible for amortization only include expenditures which are directly incident to the creation of the corporation or business. Preopening or startup expenses, such as employee training expenses, are ineligible for amortization under the business organizational expense provisions.

Investigatory expenses

Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business. Business investigatory expenses may be of either a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business.

Business investigatory expenses generally are nondeductible regardless of whether they are incurred by an existing business in relation to another business or by a taxpayer who is not in any business. However, taxpayers may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business.[1] Nevertheless, business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.

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[1] See *Harris W. Seed*, 52 T.C. 880 (1969), *acq.*, 1970–2 C.B. xxi; Rev. Rul. 77–254, 1977–2 C.B. 63.

Startup costs

Startup or preopening expenses are costs which are incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation. Generally, the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of the particular business operation to which they relate. Such costs may be incurred by a party who is not engaged in any existing business, or by a party with an existing business who begins a new one that is unrelated, or only tangentially related, to his or her existing business.

Startup costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records. However, startup expenses also may refer to certain items related to the establishment and operation of a business which are nondeductible and nonamortizable even if they are incurred subsequent to commencement of business operations. These nondeductible and nonamortizable expenses either may be of a purely capital nature, or may be capitalizable simply because they relate to a business with an indeterminate life.

Reasons for change

The committee believes that the provision for the amortization of business startup and investigatory expenses will encourage formation of new businesses and decrease controversy and litigation arising under present law with respect to the proper income tax classification of startup expenditures.

Explanation of provision

In general

Under the provision, business startup expenditures may be amortized, at the election of the taxpayer, over a period of not less than 60 months.

Eligible expenditures

In general, expenditures eligible for amortization must satisfy two requirements. First, the expenditure must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer. Second, the expenditure involved must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Under the provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. Eligible expenses also include startup costs which are incurred subsequent to a decision to establish a particular business and prior to the time when the business begins. For example, startup costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up prospective distributors, suppliers or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services.

In the case of an existing business, eligible startup expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible. The determination of whether there is an expansion of an existing trade or business or a creation or acquisition of a new trade or business is to be based on the facts and circumstances of each case as under present law.

Startup expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowable to an existing trade or business for the taxable year in which the expenditure was paid or incurred. Thus, amounts paid or incurred in connection with the sale of stock, securities, or partnership interests are not within the definition of startup expenditures, e.g., securities registration expenses, underwriters' commissions, etc., are not startup expenditures. In addition, the amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life, including expenses incident to a lease and leasehold improvements. Whether an amount is consideration paid to acquire a business (or an interest therein) depends upon the facts and circumstances of the situation. Corporate or partnership organizational expenditures which may be amortized under provisions of present law (Code sec. 248 or 709) are covered by those amortization provisions rather than this provision.

Trade or business requirement

Expenditures must relate to the investigation or creation of an active trade or business (within the meaning of Code sec. 162). Thus, expenditures attributable to an investment are not eligible for amortization under this provision. For this purpose, an activity with respect to which expenses are deductible only as itemized deductions for individuals (Code sec. 212) is not considered to be a trade or business. In addition, an activity is not considered to be a trade or business activity solely because the property used in the activity may be eligible for special capital gain or ordinary loss treatment under Code section 1231. Further, in the case of rental activities, there must be significant furnishing of services incident to the rentals to constitute an active business (within the meaning of Code sec. 162) rather than an investment. Thus, a rental activity is not considered to be an active trade or business solely because deductions attributable to it are allowable in computing adjusted gross income (Code sec. 62(5)). In general, the operation of an apartment complex, an office building, or a shopping center would constitute an active trade or business.

Investigatory expenses for acquisition of existing businesses

In addition to the active business requirement applicable to the entity, in the case of investigatory expenditures incurred by a taxpayer with respect to the acquisition of an existing trade or business, the taxpayer will be considered to have entered into a trade or business only if the taxpayer has an equity interest in, and actively participates in the management of, the trade or business. For this purpose, a taxpayer will not be considered to have a qualifying interest with respect to an investment represented by a bond or other debt instrument (even if convertible), preferred stock, or a limited partnership interest.

A sole proprietor would always be considered to have an operator equity interest in the trade or business. In the case of a taxpayer incurring investigatory expenses with respect to the acquisition of common stock, a taxpayer would usually be considered to have acquired an investment interest rather than a qualifying trade or business interest. Thus, investigatory expenses attributable to the acquisition of corporate stock generally will not be eligible for amortization. (As under present law, certain investment counseling and similar expenses paid or incurred with respect to investments held by an individual investor would be currently deductible as an itemized deduction for the production of income, etc., under Code section 212.) However, if in substance, a transaction is the acquisition of the assets of a trade or business, the investigatory expenses are eligible for amortization even though one of the steps of the transaction involved the acquisition of stock, e.g., the acquisition of a corporation which is then liquidated. Further, for example, a corporate taxpayer will be considered to have acquired the trade or business assets of an acquired corporation, rather than having made a portfolio investment in stock, if the acquired corporation becomes a member of an affiliated group which includes the taxpayer incurring the investigatory expenses and a consolidated income tax return is filed for that group.

In the case of the acquisition of a general partnership interest, the taxpayer could be considered to have acquired an active interest if the taxpayer actively participates in the management of the trade or business.

Taxpayer eligible for amortization

In general, the amortization deduction is allowable to the taxpayer who incurs the startup expenditures and enters the trade or business. In the case of startup expenditures incurred by a corporate taxpayer (including a subchapter S corporation), the amortization deduction is to be taken on the income tax return for that corporation and is not deductible as a special item to any shareholder. In the case of a sole proprietor, the amortization deduction is allowable as a deduction for the trade or business with respect to which the startup expenditure were paid or incurred. In the case of startup expenditures incurred by a partnership, the amortization deduction is to be taken into account in computing the taxable income of the partnership (except to the extent it may be required to be taken into account separately under regulations prescribed under Code sec. 702(a)(7)). In the case of qualifying investigatory expenses incurred in connection with the acquisition of a partnership interest, the amortization deduction is to be taken by the partner who incurred such expenses.

Amortization period

Under the provision, the trade or business actually must be entered into (or "begin") before an amortization period can start. Therefore, no deduction is allowed under the provision with respect to items incurred incident to a trade or business which actually is not commenced or acquired by the taxpayer.

The amortization period of not less than 60 months commences with the month in which a business begins. For purposes of this determination, an acquired trade or business is treated as beginning with the month in which a taxpayer acquires it. The month of acquisition is to be determined with regard to the economic substance of each situation. Generally, it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for the amortization of organizational expenditures (Code secs. 248 and 709). Generally, if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

Since the minimum amortization period allowed by the provision is 60 months, the election is inapplicable to businesses which have an ascertainable useful life of less than 60 months. Expenditures related to such businesses remain subject to the provisions of existing law.

The generally applicable income tax rules apply in the case of any amount subject to an election which is unamortized upon a termination of the trade or business. Therefore, in an appropriate instance, a taxpayer may deduct any unamortized amount as a loss (Code sec. 165) or an unamortized amount might be carried over to the taxpayer's successor in interest (e.g., see Rev. Rul. 70–241, 1970–1 C.B. 84, relating to the treatment of unamortized organizational expenses in connection with a reorganization qualifying under Code section 368(a)(1)(F)).

Scope and manner of election

Amortization elections generally must be made at the time, and in the manner, specified in Treasury regulations.[2] Elections, however, may not be made later than the time for filing the return (including extensions) for the taxable year in which the business begins. It is anticipated that election procedures will be similar to those used under sections 248 and 709 of the Code (relating to certain organization fees), and that elections may not be made on a conditional basis.

Once an amortization period is selected, it may not be changed. Thereafter, the selected period must be used in computing taxable income for the taxable year in which the election is made and for all subsequent taxable years.

The election applies to all eligible expenditures paid or incurred by the taxpayer in connection with a newly-created or acquired business.

Effective date

The provision applies to amounts paid or incurred after July 29, 1980.

Revenue effect

It is estimated that the provision would reduce fiscal year budget receipts by $22 million in 1981, $73 million in 1982, $121 million in 1983, $180 million in 1984, and $254 million in 1985.

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[2] In the case of startup expenditures paid or incurred by a partnership in connection with the creation of a new, or acquisition of an existing, trade or business, an amortization election would have to be made by the partnership rather than the individual partners (sec. 703(b)).

C. Revision of Source Rules for Income from Certain Leased Aircraft, Vessels, and Spacecraft (sec. 105 of the bill and sec. 861 of the Code)

Present law

The source of income or loss from the rental of personal property generally depends on whether the property is used inside or outside the United States. Under this rule, income from the lease of a vessel or aircraft would be treated as income from sources without the United States to the extent that the rental payments were attributable to use of the equipment outside the United States. Similarly, income from the lease of a spacecraft would be from sources outside the United States.

Typically, under a lease financing of equipment (i.e., the equipment is purchased by a financial institution and leased to the user), the lease produces a tax loss during its early years to the lessor (primarily as a result of accelerated depreciation or amortization deductions). Where the equipment is used outside the United States, the loss arising on the lease is considered to be a foreign source loss under the generally applicable source rules described above. The characterization of the loss as foreign source operates to reduce the lessor's foreign source taxable income and thus its foreign tax credit limitation. Under certain circumstances, this may cause the lessor to lose a foreign tax credit, to which it would otherwise be entitled, for foreign taxes paid with respect to its other foreign operations. As a result, this type of lease-financing transaction could be less attractive than a lease-financing transaction involving equipment to be used exclusively in the United States.

In the case of ships and aircraft, which often are financed through long-term leases from financial institutions, lessors expressed concern about the loss of foreign tax credits. Under the Revenue Act of 1971, lessors of certain ships and aircraft were given an election to treat all income and loss from the rental of the ships or aircraft as from sources within the United States (Code sec. 861(e)). Under this provision, if a taxpayer owns an aircraft or vessel which is eligible for the investment tax credit (or would be if not used by a government) and leases the aircraft or vessel to a United States person, other than a member of the same controlled group of corporations as the taxpayer, and if the aircraft or vessel is manufactured or constructed in the United States, then the taxpayer may elect, for any taxable year ending after the commencement of such lease, to treat all amounts includible in gross income with respect to the aircraft or vessel (whether during or after the period of any such lease), including gain from sale, exchange, or other disposition of such aircraft or vessel, as income from sources within the United States. As a corollary to this rule, losses from the lease would also be treated as from U.S. sources. The election may not be revoked without the consent of the Treasury. Moreover, if the ship or aircraft is transferred in certain transactions where gain is not fully recognized, the transferee is also bound by the election.

A similar problem also arose with respect to lease-financed U.S. railroad rolling stock used temporarily in Canada or Mexico. Under the Revenue Act of 1978, lessors generally are required, on a non-elective basis, to treat all income or loss from the rolling stock as from U.S. sources if it is expected that the leased rolling stock will be used predominantly within the United States.

Property which is used predominantly outside the United States, or which is used by a government or international organization, is generally not eligible for the investment tax credit. Exceptions are made to the requirement for use in the United States for U.S. documented ships or aircraft, rolling stock of domestic railroads, and certain other property. Under the Revenue Act of 1971, this requirement is also waived for any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962) or interest in such a satellite of a U.S. person. In addition, the 1971 Act waives the governmental use restriction for property used by the International Telecommunications Satellite Consortium (INTELSAT).[1]

Reasons for change

The foreign tax credit rules are designed to prevent double taxation of the same income by the United States and foreign countries. The credit generally operates on the principle that the country in which income arises has the primary right to tax the income. Thus, where a U.S. taxpayer derives income from a foreign country, any taxes imposed by that country on the income are allowed as a credit against the U.S. tax on the income. In order to prevent the foreign tax credit from offsetting more than the U.S. tax on income which is potentially subject to double taxation, the credit is limited to the taxpayer's pre-credit tax on its foreign source income (computed on an overall basis). In view of the purpose to prevent double taxation (without allowing the credit to exceed the amount necessary to do so), the source rules used in computing the limitation are generally designed to identify as foreign source income that income which might reasonably be subject to foreign tax.

Where the lease property is a vessel, aircraft, or spacecraft used in international traffic, the present rules governing the source of income derived from the lease of personal property appear to produce results which by that standard are somewhat anomalous. The present source rules for rental income turn on the physical location of the property—the income is U.S. source if the property is physically located in the United States, foreign source if it is not. Where a U.S. taxpayer operates a ship, aircraft, or spacecraft in international traffic, the operating income occasionally is subject to tax by a country in which the operations are temporarily conducted; therefore, it is not unreasonable to treat operating income as foreign source where the craft is used outside the United States. However, where the craft is leased to the U.S. operator by another U.S. taxpayer, it evidently is

[1]Section 108 of the bill would extend this waiver to property used by the International Maritime Satellite Organization (INMARST).

very unlikely that any foreign government will attempt to tax the lease payments received by the U.S. lessor from the U.S. operator even if the craft is located outside the United States. (This is particularly true where the craft seldom, if ever, is located in a foreign country.)

Accordingly, consistent with the objectives of the source rules outlined above, the committee decided that lease payments on vessels aircraft, and spacecraft received by U.S. lessors from U.S. persons will be treated as U.S. source income where the property qualifies for the investment credit.

Explanation of provision

In situations in which lessors of ships or aircraft may currently elect to have all income or loss from the equipment treated as from U.S. sources, such treatment will become mandatory. The rule is also extended to apply to spacecraft on the same terms as ships and aircraft. Thus, income (or loss) from the rental of a spacecraft, aircraft, or vessel (a "craft") will be treated as U.S. source if (1) the craft qualifies for the investment tax credit (or would so qualify but for the fact that it is leased to a government unit), (2) the craft is leased to a U.S. person (other than a member of the same affiliated group of corportations as the taxpayer), and (3) the craft is manufactured or constructed in the United States. Once this rule applies to a craft, it will apply in all subsequent years in which the taxpayer owns the craft, even if it is leased to a foreign person. Thus, all income or loss, including gains from the sale, exchange, or other disposition of the craft, will be U.S. source. Also, if the craft is transferred in certain transactions in which gain is not fully recognized, the transferee will also be subject to the special source rule with respect to the craft.

Effective date

The provision is effective with respect to equipment first leased after the date of enactment. Other equipment will continue to be subject to the rules of prior law and, if subject to an election under section 861(e), will remain subject to that election.

Revenue effect

It is estimated that this provision will reduce budget receipts by a negligible amount annually through fiscal year 1985.

D. Tax Rates Applicable to Nonexempt Income of Homeowners Associations (sec. 104 of the bill and sec. 528(b) of the Code)

Present law

Homeowners associations

Under present law, a qualified homeowners association (a condominium management association or a residential real estate association) may elect to be treated as a tax-exempt organization (Code sec. 528). If an election is made, the association will not be taxed on "exempt function income." Exempt function income means membership dues, fees, and assessments received from persons who own residential units in the particular condominium or subdivision and who are members of the association.

The association will be taxed, however, on income which is not exempt function income. For example, any interest earned on amounts set aside in a sinking fund for future improvements is taxable. Similarly, any amount paid by persons who are not members of the association for use of the association's facilities, such as tennis courts, swimming pools, golf courses, etc., is taxable. Further, any amount paid by members for special use of the association's facilities, the use of which would not be available to all the members as a result of having paid the membership dues, fees, or assessments required to be paid by all members of the association, will be taxable. For example, if the membership dues, fees, or assessments do not entitle a member to use the association's party room or to use the swimming pool after a certain time period, then amounts paid for this use are taxable to the association.

Deductions from nonexempt income are allowed for expenses directly related to the production of such income, and a $100 deduction against taxable income is provided so that associations with only a minimal amount of taxable income will not be subject to tax. However, a net operating loss deduction is not allowed, and the special deductions for corporations (such as the dividends received deduction) are not allowed.

A homeowners association is taxed on its taxable income at the highest corporate rate (46 percent). If the association has net long-term capital gain, the tax rate is 28 percent for determining the association's alternative tax for capital gains.

Corporate tax rates

Under present law, a corporation is taxed at graduated rates on the first $100,000 of taxable income. The corporate rates are 17 percent on the first $25,000 of taxable income, 20 percent on the next $25,000, 30 percent on the next $25,000, 40 percent on the next $25,000, and 46 percent on all taxable income above $100,000. The alternative tax rate for capital gains is 28 percent.

The Code contains rules to prevent abuse of the graduated rate structure. A controlled group of corporations is limited in the aggregate to a maximum of $25,000 of taxable income in each of the rate brackets below the 46 percent bracket (Code sec. 1561). These rules are used to prevent income splitting by such commonly controlled corporations.

Reasons for change

The basic rationale for the tax treatment of homeowners associations in the Code is that activities which would not be taxed if engaged in by homeowners individually (for example, maintenance of their property or the payment of utility bills) should not be subject to tax when the individuals band together in an association. An extension of this principle would appear to be that the rate of taxation on invested funds of the asociation should approximate the rate that would be imposed on the funds if they were invested by individual members of the association.

On the other hand, taxation of an association at the regular corporate rates would generally result in the taxation of this income at a rate of 17 percent. Members of homeowners associations are likely to be in higher tax brackets. In addition, there are apparently no rules which would prevent abuse of the graduated rate structure by commonly controlled or related homeowners associations. The tests for commonly controlled corporations would not appear to be effective for nonprofit corporations which do not normally have stock ownership. Also, there appear to be almost no barriers to prevent the multiplication of organizations in order to minimize the tax burden.

The committee believes that the taxable income of a homeowners association should not be subject to tax at higher rates than the rates which would normally apply to such income if it were taxable to the members of the association. However, it would be too complicated to require a pass through of ratable portions of an association's income to its members. Consequently, the committee believes that it is appropriate to tax the income of homeowners associations at a flat rate of 30 percent, which may reasonably approximate the average marginal income tax rate of the members of these associations.

Explanation of provisions

Under this provision, taxable income of a homeowners association will be taxed at a rate of 30 percent. This rate applies to both ordinary income and capital gains.

Effective date

This provision applies to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $1 million in fiscal year 1981, and $2 million annually in fiscal years 1982 through 1985.

E. Tax Treatment of Certain Income of Mutual or Cooperative Telephone and Electric Companies (sec. 105 of the bill and secs. 501(c)(12) and 513 of the Code)

Present law

Rural cooperatives

Under present law (Code sec. 501(c)(12)), a mutual or cooperative telephone company qualifies for exemption from Federal income taxation only if at least 85 percent of its income consists of "amounts collected from members for the sole purpose of meeting losses and expenses." In determining whether this member-income test has been satisfied, amounts of credits accrued or received by a mutual or cooperative telephone company from another company for communications services on calls involving members of the telephone cooperatives are not taken into account.

Similarly, a rural electric cooperative may qualify for exemption from Federal income taxation under Code section 501(c)(12) if it satisfies the 85-percent member-income test.[1]

Tax on unrelated business income

Under present law, most organizations which are generally tax exempt under the Internal Revenue Code are nonetheless subject to tax on unrelated business taxable income (Code sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under Code sec. 501(a))[2] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Reasons for change

Recently, the Internal Revenue Service has indicated that income from the rental of poles (*e.g.*, payments by a rural electric cooperative for use of a rural telephone cooperative's poles) and display listings in "Yellow Page" directories may be included in nonmember income of rural cooperatives.

The committee believes that income from pole rentals and display listings should not be treated as nonmember income for purposes of the

[1] See Rev. Rul. 65-99, 1965-1 C.B. 242; Rev. Rul. 65-174, 1965-2, C.B. 169. In addition, certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area are exempt from taxation under Code section 501(c)(4) even though, generally because of TVA requirements, they do not meet the 85-percent member-income test. See *U.S.* v. *Pickwick Electric Membership Corp.*, 158 F. 2d 272 (6th Cir. 1946).

[2] In this paragraph, references to "tax-exempt organizations" do not include social clubs (Code sec. 501(c)(7)) and employees' beneficiary associations (Code sec. 501(c)(9)), which are taxable on investment income of all types as well as unrelated business income. The term "tax-exempt organizations," as used in this paragraph also does not include political organizations (described in Code sec. 527) and homeowners associations (described in Code sec. 528).

85-percent member-income test and that income from pole rentals should be exempt from the tax on unrelated business taxable income.

Explanation of provisions

The bill provides that, in applying the 85-percent member-income test to a mutual or cooperative telephone company, any income from qualified pole rentals or from display listings in a telephone directory is to be disregarded. Also, in applying the 85-percent non-member-income test to mutual or cooperative electric companies, any income from qualified pole rentals is to be disregarded. Income from qualified pole rentals generally means any income from the sale of the right to use any pole (or other structure) (1) which is used by the cooperative in providing telephone or electric services to its members, and (2) the use for which the pole is rented involves support of wires used for the transmission of electricity or of telephone or other communications.

The bill also provides that the engaging in activities which result in the receipt of qualified pole rentals is not an unrelated trade or business for a mutual or cooperative telephone or electric company. Thus, such rentals would not be subject to the tax on unrelated business taxable income.

Effective date

The provisions relating to the 85-percent member-income test apply to all taxable years to which the Internal Revenue Code of 1954 applies. The provisions relating to the treatment of qualified pole rentals for purposes of the unrelated business tax apply to taxable years beginning after December 31, 1969.

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million in fiscal year 1981 and by less than $2 million annually thereafter.

F. Refund of Taxes on Certain State Police Officer Subsistence Allowances (sec. 106 of the bill)

Present law

Code section 119, which was enacted in 1954, excludes from an employee's gross income the value of employer-furnished meals if they are provided for the employer's convenience, on its business premises, and for substantially noncompensatory reasons. The legislative history of section 119 indicates that the exclusion applies only to the value of meals furnished in kind.[1]

Although in 1954 Congress provided for an exclusion of up to $5.00 per day of statutory subsistence allowances paid to police officers, this provision was repealed in 1958 "to bring the tax treatment of subsistence allowances for police officials into line with the treatment of such allowances in the case of other taxpayers. . . ."[2]

On November 29, 1977, the Supreme Court decided *Commissioner* v. *Kowalski*, 434 U.S. 77, which held that cash meal allowances paid to a state trooper were includible in income since the section 119 exclusion applied only to meals furnished in kind. This decision resolved a conflict among the various appellate courts as to the taxability of cash meal allowances.

In response to the *Kowalski* decision, Congress enacted section 3 of Public Law 95–427. Under that section, the Supreme Court's decision generally applies only prospectively. The Act allowed an exclusion from gross income for certain subsistence allowances received by an officer during the years 1970 through 1976 to the extent that the allowances were not included in income on the officer's income tax return. It also applied to all State police officer subsistence allowances received in 1977 without regard to an officer's treatment of those allowances on his or her return.

Public Law 95–427 did not authorize the refund of taxes paid prior to 1977 on such cash allowances if those payments had been included in income on the officer's income tax return. Thus, the Act was restricted to cases where officers might experience hardships in paying income tax deficiencies assessed with respect to cash meal allowances.

Reasons for change

After reviewing the income tax treatment of cash meal allowances received by State police officers during 1970 through 1976, the committee believes that it is appropriate to amend Public Law 95–427 to allow a credit or refund of taxes paid by such an officer with respect to those cash meal allowances which were included in gross income for calendar years 1974, 1975, and 1976.

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[1] S. Rept. No. 1622, 83d Cong., 2d Sess. 190–191 (1954).

[2] H.R. Rep. No. 775, 85th Cong., 1st Sess. 7 (1957), 1958–3 C.B. 817.

Explanation of provision

The provision amends Public Law 95–427 to allow a credit or refund of taxes paid by State police officers with respect to cash meal allowances received during 1974, 1975, and 1976, whether or not the cash payments had been reported in gross income. As a result, the amended version of Public Law 95–427 will apply, on an elective basis, to all cash meal allowances received by all State police officers after 1973 and before 1978.

Effective date

The provision is effective upon enactment. The period of limitations for making refunds (or any other rule of law) will not operate to bar any claim for refund filed within one year of the date of enactment of the provision.

Revenue effect

It is estimated that this provision will result in a one-time decrease in budget receipts of $3 million in fiscal year 1981. This represents refunds or credits for taxes paid by State police officers with respect to cash meal allowances during 1974, 1975, and 1976 when the allowances were reported in income.

G. Clarification of Limitation on Deductibility of Certain Entertainment Facility Expenses Includible in Income of Recipient (sec. 107 of the bill and sec. 274 of the Code)

Present law

Prior to the enactment of the Revenue Act of 1978, expenses incurred with respect to entertainment facilities [1] were deductible if they were ordinary and necessary, the facility was used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it was used), and the expense in question was related directly to the active conduct of the taxpayer's business. For this purpose, entertainment facility expenses included dues or fees paid to any social, athletic, or sporting club or organization. Dues or fees paid to professional associations, civic organizations, or to clubs operated solely to provide meals under circumstances normally considered to be conducive to business discussions generally were not considered to be entertainment facility expenses.

In determining whether an entertainment facility was used primarily for business purposes, all the taxpayer's ordinary and necessary business use of the facility was taken into account. Once it was determined that the facility was used primarily for business, the portion of the expenses which were related directly to the active conduct of the taxpayer's business could be deducted.

The Revenue Act of 1978 provided generally that no deduction was allowable for any entertainment facility expense. However, the Act retained a number of exceptions to the general rule that existed under prior law. One of these relates to expenses treated as employee compensation (Code sec. 274(e)(3)). Under this exception, expenses for goods, services, and facilities are not subject to the disallowance rules to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, as compensation to an employee on the taxpayer's return and as wages to the employee for purposes of income tax withholding. Thus, in the case of facility expenses which satisfy this exception, the Act retained the rules of prior law which formerly had been applied to expenses treated as employee compensation.

The Technical Corrections Act of 1979 provided that the provision disallowing expenses for entertainment facilities did not apply to expenses paid or incurred in 1979 or 1980 where the entertainment facilities are provided to a nonemployee of the payor, the amount of the expense is includible in the gross income of the recipient of the entertainment facilities as compensation for services or as a prize or award, and the payor complies with any required reporting of information

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[1] An entertainment facility generally is any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, an activity normally considered to be of an entertainment nature.

(i.e., an information return (Form 1099) is furnished to the Internal Revenue Service (but not the recipient) for amounts in excess of $600).

Reasons for change

Present law already provides an exception to the disallowance rule for entertainment facilities in the case of facilities provided to employees. In such a case, the amount of the income is reported to the Internal Revenue Service regardless of the amount involved. The committee believes that a similar rule should apply to facilities provided to nonemployees so long as it is includible in the income of the recipient as a prize or award or for services rendered and information about the transaction is provided to the Internal Revenue Service (where required) regardless of the amount involved.

Explanation of provision

Under this provision, the general rule for the disallowance of expenses for entertainment, amusement, or recreation expenses (Code sec. 274(a)) does not apply to expenses which are includible in the gross income of the recipient of the entertainment, amusement, or recreation as compensation for services or as a prize or award under Code section 74. This provision will not apply if the taxpayer fails to include the amount in any information return (Form 1099) which is required to be filed with the Internal Revenue Service (or would be required except that the amount is less than $600).

Effective date

The provision is effective for expenses paid or incurred after December 31, 1980, in taxable years ending after that date.

Revenue effect

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

H. Investment Tax Credit for Certain Property Used in Maritime Satellite Communications (sec. 108 of the bill and sec. 48 of the Code)

Present law

Under present law, a credit against tax liability is provided with respect to a taxpayer's investment in certain types of depreciable business assets. Generally, the investment credit rate is 10 percent of qualified investment. Qualifying property for purposes of this investment tax credit includes tangible personal property and other tangible property used as an integral part of certain activities, including the furnishing of communications services. However, property which otherwise qualifies will generally be excluded from the credit if it is used predominantly outside of the United States or is used by a governmental unit or an international organization.

Under provisions enacted in the Revenue Act of 1971, these exclusions are made inapplicable to any interest of a United States person in communications satellites and property used by the International Telecommunications Satellite Organization (INTELSAT), an international joint venture established to develop and operate the space segment of the global commercial communications satellite system. As a result, the Communications Satellite Corporation (COMSAT) is entitled to the credit for its investments in the INTELSAT system. COMSAT, a private, for-profit corporation created pursuant to the Communications Satellite Act of 1962, is the designated United States participant in INTELSAT.

During the 95th Congress, the International Maritime Satellite Telecommunications Act (P.L. 95-564) amended the Communications Satellite Act of 1962 to designate COMSAT as the United States participant in the International Maritime Satellite Organization (INMARSAT). INMARSAT is an international organization, similar to structure and operation to INTELAST, which is being established to develop and operate a global maritime satellite telecommunications system.

Reasons for change

The committee believes that it is appropriate to extend the investment credit to interests of United States persons in property used by the International Maritime Satellite Organization.

Explanation of provision

This provision of the bill will make the international organization exclusion under the investment tax credit inapplicable to property used by the International Maritime Satellite Organization

(INMARSAT). As a result, the investment tax credit will be available for investments by COMSAT or other United States persons in property owned or used by INMARSAT. This is the same treatment as was provided in 1971 for investments in the INTELSAT system.

Effective date

This provision will apply to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will have an insignificant effect on budget receipts through fiscal year 1985.

I. Exemption from Debt-Financed Income Rules for Certain Real Estate Investments of Tax-Exempt Employees' Trusts (sec. 109 of the bill and sec. 514(c) of the Code)

Present law

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

This scheme of taxation applies to tax-exempt pension, etc. trusts described in Code section 401(a) ("qualified retirement plans") as well as most other tax-exempt organizations (described in the various paragraphs of Code sec. 501(c)).

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

The Tax Reform Act of 1969 provided (in the so-called "Clay Brown provision") that an exempt organization's income from "debt-financed property," which is not used for its exempt function, is to be subject to tax in the proportion in which the property is financed by debt (Code secs. 512(b)(4) and 514). In general, debt-financed property is defined as any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year or during the 12 months prior to disposition if the property is disposed of during the taxable year (Code sec. 514(b)(1)). A debt constitutes acquisition indebtedness with respect to property if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred "but for" the acquisition or improvement of the property.[2]

There appear to be situations in which the unrelated debt-financed income provisions may not apply to investments by retirement plans

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

[2] There are several exceptions from the term "acquisition indebtedness." For instance, one exception is indebtedness on property which an exempt organization receives by devise, bequest, or under certain conditions, by gift. Also, the term "acquisition indebtedness" does not include indebtedness which was necessarily incurred in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Special exceptions are also provided for the sale of annuities and for debts insured by the Federal Housing Administration to finance low- and moderate-income housing.

(or other exempt organizations) which are made indirectly through a financial intermediary, for example, through an insurance company segregated asset account (Code sec. 801(g)), rather than made directly.

Reasons for change

The committee believes a limited exception should be made to the debt-financed income rules for certain debt-financed real estate investments by qualified retirement plans. While the "Clay Brown" provisions were designed in part to prevent uncontrolled growth of exempt organizations through investments financed with debt, the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose—the payment of employee benefits. Accordingly, the committee believes that it is inappropriate to continue the present law restrictions on debt-financed income to the extent that they discourage prudent debt-financed real estate investments by these trusts.

Trustees of these plans are desirous of investing in real estate for diversification and to offset inflation. Debt-financing is common in real estate investments. (For example, a debt-financed real estate acquisition by a trust may be economically advantageous if it can be made by assuming or taking subject to a favorable existing mortgage on the property.)[3] The committee also believes that, in order to alleviate a competitive problem, it is appropriate to allow qualified plans to make debt-financed investments directly.

The committee believes that specifically drawn prohibitions of debt-financed acquisitions with certain characteristics can eliminate the most egregious abuses addressed by the 1969 legislation while at the same time exempting from tax the income from debt-financed real estate received by qualified retirement plans.

The committee believes that it is appropriate to limit this change to real estate investments of qualified retirement trusts because, in addition to the considerations discussed above, the assets of such trusts will ultimately be used to pay taxable benefits to individual recipients whereas the investment assets of other organizations exempt under Code section 501(a) are not likely to be used for the purpose of providing benefits taxable at individual rates.[4]

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[3] It may also be argued that if a qualified trust is subject to tax on a portion of the income from debt-financed real estate, it would be at a competitive disadvantage when compared to a taxable investor because the trust could use only straight line depreciation while other taxpayers can utilize accelerated depreciation under some circumstances. This argument overlooks the fact that, in many cases, component depreciation may be utilized to achieve a degree of acceleration which may be comparable to that achievable under accelerated methods of depreciation.

[4] Thus, exempting income of qualified trusts (much of which may be capital gains) will normally result only in deferral and, because of a change in character, may eventually be taxed at higher rates to the individuals than it would have been to the trust. By contrast, exempting debt-financed income of other tax-exempt organizations from unrelated business income tax is not likely to result in a later increase of taxable income of others.

Explanation of provision

The bill provides that, with certain exceptions, indebtedness incurred by a qualified trust as a result of the acquisition or improvement of real property will not be considered "acquisition indebtedness."[5] Thus, income or gain received from or with respect to such debt-financed real property will not be treated as income from debt-financed property.

For these purposes, "real property" is intended to encompass interests in real property, including sole fee ownership, as well as interests in joint ventures and partnerships which acquire real estate for investment.

The bill provides that in five types of situations the new exception to the general definition of acquisition indebtedness will not apply.

The first situation is one in which the acquisition price is not a fixed amount determined as of the date of acquisition. However, the fact that the terms of a sales contract provide for price adjustments due to customary closing adjustments (such as proration of property taxes), as well as price adjustments, in an amount fixed in the contract, dependent upon subsequent resolution of limited, external contingencies such as zoning approvals, title clearances, and the removal of of easements, will not cause the acquisition price to be treated as not being a fixed amount determined as of the date of acquisition.

The second situation is where either the amount of any indebtedness, the amount payable in respect of the indebtedness, or the time for making any payments, is dependent (in whole or in part) upon the future revenues, income, or profits derived from debt-financed real property. Accordingly, a trust's income or gain from the debt-financed "bootstrap" acquisitions will continue to be subject to tax.

The third type of situation is where the property is leased by the trust to the seller, or to a person related to the seller. The attribution rules of Code section 267(b) are applied to determine whether a person is related to the seller. Accordingly, a qualified trust's income or gain from "sale-leaseback" transactions will not be exempt from the tax on unrelated debt-financed income.

A fourth situation in which the exemption to the acquisition indebtedness rule will not apply is if the property is acquired by a qualified trust from a person related to the plan under which the trust is formed or if such property is leased to such a related person. For these purposes, related persons include (1) an employer any of whose employees are covered by the plan (Code sec. 4975(e)(2)(C)), (2) a person which has a 50 percent or more ownership interest in such an employer or in which the employer has a 50 percent or more interest (Code secs. 4975(e)(2)(E) and (G)), (3) a member of the family of any individual described in (1) or (2) (Code sec. 4975(e)(2)(F)), or (4) an officer, director, 10 percent or more shareholder, or a highly compensated employee of a person described in (1) or (2) (Code sec. 4975(e)(2)(H)). This restriction is necessary because sales of prop-

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[5] This provision is not intended to affect the definition of acquisition indebtedness in other circumstances, such as where the indebtedness relates to personal property. See *Elliott Knitwear Profit Sharing Plan* v. *Commissioner*, 614 F. 2d 347 (3rd Cir. 980) aff'g 17 T.C. 765 (1979).

erty at bargain rates to the trust (and certain types of leases) would permit an employer to make indirect contributions to the trust in excess of the amounts otherwise permitted by the Code and obtain the effect of allowance of a deduction (by reduction in purchase price) for excessive contributions. This also could result in discriminatory contributions in favor of employees who are officers, shareholders or highly compensated as well as avoidance of limitations on contributions and benefits.

The final situation where the new exception will not apply is where the seller, a person related to the seller (under Code sec. 267(b)), or a person related to the plan (under the rules described in the preceding paragraph) provides nonrecourse financing for the transaction, and either (1) the debt is subordinate to any other indebtedness on the property or (2) the debt bears interest at a rate which is significantly less than the rate available from unrelated parties at the time the indebtedness is incurred. This provision is intended to prevent the use of inflated purchase prices—with the seller providing financing at favorable rates while receiving increased income taxable as capital gains—and not to preclude a qualified trust from obtaining a favorable rate of interest. Accordingly, a rate of interest obtained from a seller that is not less than 90 percent of the rate of interest that could be obtained from an unrelated party for a comparable type of loan at the time the indebtedness was incurred will not be considered to be "significantly less."

In the case of real property investments made through joint ventures or partnerships, the debt of the venture or partnership is intended to be treated as debt of the venturers or partners in a manner similar to the provisions of Code section 752 and the regulations thereunder. After such attribution, the debt will be tested to determine whether the tests for the exception from the definition of acquisition indebtedness are satisfied.

Effective date

These provisions apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $10 million annually in fiscal years 1981 through 1985. It could cause significant revenue losses in later years.

I. Provisions Relating to Employee Stock Ownership and Cafeteria Plans

1. Cash distribution option and put option for stock bonus plans (sec. 201 of the bill and new sec. 401(a)(23) of the Code)

Present law

Under present law, tax-qualified stock bonus plans must generally distribute stock to participants entitled to a distribution. However, a stock bonus plan which is either a tax credit employee stock ownership plan or an employee stock ownership plan may distribute cash, subject to a participant's right to demand that benefits be distributed in the form of employer securities.

Reasons for change

The committee has determined that a tax-qualified stock bonus plan generally should be eligible for the same rules with respect to cash and stock distributions to participants which govern tax credit employee stock ownership plans and employee stock ownership plans.

Explanation of provision

The provision would permit a tax-qualified stock bonus plan to distribute cash to a participant entitled to a distribution, subject to the participant's right to demand that benefits be distributed in the form of employer stock. If a stock bonus plan provides for cash distributions and if stock which is distributed is not readily tradable on an established market, the participant must have the right to require the employer to repurchase the stock.

Effective date

The provision is effective for plan years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

2. Special limitation for tax credit employee stock ownership plans and employee stock ownership plans (sec. 202 of the bill and sec. 415(c)(6)(A) of the Code)

Present law

Under present law, the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan may be increased, provided certain requirements with respect to allocations of employer contributions are met. The amount of such increase is the lesser of (1) the usual dollar limitation on annual additions to a participant's account or (2) the amount of employer securities contributed to the plan.[1]

Reasons for change

The committee has determined that it is necessary to make a clarifying change to the rule of present law which allows an increase in the limitation on contributions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan. The change will make it clear that cash used to purchase employer securities is included for purposes of determining the increased limitation on annual additions to a participant's account.

Explanation of provision

Under the provision, the increase in the dollar limitation on annual additions with respect to a participant in a tax credit employee stock ownership plan or an employee stock ownership plan (provided certain requirements of present law are met with respect to allocations under the plan) would be the lesser of (1) the usual dollar limitation on annual additions to a participant's account, or (2) the amount of employer securities (or cash used to acquire such securities) contributed to the plan.

Effective date

The provision is effective for limitation years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

3. Valuation of employer securities in tax credit employee stock ownership plans (sec. 203 of the bill and sec. 48(n)(6)(B)(i) of the Code)

Present law

Under present law, the value of employer securities listed on a national exchange which are contributed to a tax credit employee stock ownership plan is the average of closing prices for such securities for the 20 consecutive trading days immediately preceding the due date for filing the employer's tax return for the year (including extensions).

Reasons for change

The committee has decided that the average closing price of employer securities during the 20 trading days preceding the date of contribution to a plan should be used to determine the value of those securities. The committee understands that the provision of present law for valuing readily tradable employer securities contributed to a

[1] Under prop. reg. § 1.415–6(g)(4)(i) if a contribution of cash is used to purchase employer securities not later than 30 days after the time for filing the employer's tax return (including extensions), then generally the cash contribution is treated as a contribution of employer securities for purposes of the special dollar limitation.

tax credit employee stock ownership plan generally causes employers to postpone contributions of employer securities to a tax credit employee stock ownership plan until the due date for filing the employer's tax return.

Explanation of provision

Under the provision, the value of employer securities listed on a national exchange and contributed to a tax credit employee stock ownership plan is the average of the closing prices of such securities for the 20 consecutive trading days immediately preceding the date of contribution to the plan.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will not have any revenue effect.

4. Participation of subsidiary corporation in a tax credit employee stock ownership plans (sec. 204 of the bill and sec. 409A(l)(4) of the Code)

Present law

The present-law rules governing tax credit employee stock ownership plans permit a 50-percent owned first-tier subsidiary of a parent corporation, and 80-percent owned second and lower-tier subsidiaries, to contribute employer securities of the parent corporation to a tax credit employee stock ownership plan.

Reasons for change

The committee believes that in the case where a first-tier subsidiary corporation owns 50 percent of a second-tier subsidiary and the first-tier subsidiary is 100-percent owned by a parent corporation, sufficient control of the second-tier subsidiary by the parent corporation exists to permit the second-tier subsidiary to contribute employer securities of the parent to a tax credit employee stock ownership plan maintained by the second-tier subsidiary.

Explanation of provision

Under the bill, if a parent corporation owns 100 percent of a first-tier subsidiary and the first-tier subsidiary owns 50 percent of a second-tier subsidiary, the second-tier subsidiary is allowed to contribute employer securities of the parent corporation to its tax credit employee stock ownership plan. In addition, parent stock could be contributed by 80-percent owned lower-tier subsidiaries in this chain.

Effective date

The provision would be effective as if included in section 141 of the Revenue Act of 1978 (qualified investment for taxable years beginning after 1978).

Revenue effect

It is estimated that this provision will not have any revenue effect.

5. Retirement savings by tax credit employee stock ownership plan participants (sec. 205 of the bill and sec. 410(b)(1) of the Code)

Present law

Under present law, an employee who is an active participant in a tax-qualified plan during a year is not eligible to make deductible contributions to an IRA (individual retirement account, individual retirement annuity, or retirement bond). Therefore, if an employee is an active participant in a tax-qualified tax credit employee stock ownership plan during a year such employee is ineligible for an IRA deduction. A plan can allow an employee to elect not to participate in a tax credit employee stock ownership plan in order to allow the employee to establish an IRA. However, the plan may be unable to satisfy certain minimum requirements of the Code relating to employee eligibility for plan participation (sec. 410(b)(1)) if substantial numbers of employees make such an election.

Reasons for change

The committee has determined that in the case where the only tax-qualified plan maintained by an employer is a tax credit employee stock ownership plan and if the value of employer securities allocated to employees' accounts under the tax credit employee stock ownership plan is relatively low, the minimum coverage requirements for tax-qualification of the tax credit employee stock ownership plan should be modified to permit employees to elect out of the plan, if the plan so provides, to establish IRAs.

Explanation of provision

Under the provision, the minimum coverage requirement for a tax credit employee stock ownership plan is changed, if a tax credit employee stock ownership plan is the only tax-qualified plan maintained by an employer. If employees are permitted to elect out of the tax credit employee stock ownership plan for the purpose of establishing IRAs, the tax credit employee stock ownership plan does not fail to meet the minimum coverage requirements of the Code if the plan benefits at least 50 percent of all employees (excluding employees who have not satisfied the minimum age and service requirements or who are otherwise permitted to be excluded), and if the total allocations under the tax credit employee stock ownership plan are equal to no more than two percent of the compensation of participating employees.

Effective date

The provision is effective for plan years beginning after December 31, 1980.

Revenue effect

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

6. Cafeteria plans permitted to provide deferred compensation under rules applicable to cash or deferred profit-sharing and stock bonus plans (sec. 206 of the bill and secs. 125 and 401(k)(2) of the Code)

Present law

A cafeteria plan is an employee benefit plan under which a participant may choose between taxable benefits and one or more nontaxable fringe benefits. Under present law, cafeteria plans are not permitted to provide deferred compensation.

Reasons for change

Both cafeteria plans and cash or deferred profit-sharing plans allow employees to choose between current compensation and other benefits. The committee believes that present law is too restrictive because it does not permit employees to choose among currently taxable compensation, deferred compensation, and fringe benefits under a single plan.

Explanation of provision

Under the provision, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

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

K. Elimination of Withholding Tax on Pensions Paid to Certain *Nonresident Aliens*

(Sec. 207 of the bill and sec. 871 of the Code)

Present law

Under present law, a nonresident alien is not subject to U.S. tax on compensation for services performed outside the United States (or certain *de minimis* services performed in the United States for a foreign employer). He is, however, generally subject to a tax of 30 percent on his investment income (interest, dividends, etc.) from U.S. sources.

If a nonresident alien receives a pension in the form of an annuity from a qualified trust or under a qualified annuity plan, and the pension is attributable to services performed outside the United States, he generally would not be subject to U.S. tax on the portion of the annuity which is attributable to his contributions or to his employer's contributions under the plan. However, he would generally be subject to the 30-percent withholding tax on the portion of the annuity attributable to investment income earned on the contributions while they were invested, unless a statutory or treaty exemption applies. Currently, there is a statutory exemption from tax on a pension paid to a nonresident alien for services performed outside the United States (or *de minimis* services within the United States for a foreign employer) if, at the time the annuity payments begin, 90 percent or more of the employees for whom contributions or benefits are provided by the plan are citizens or residents of the United States. (Sec. 871(f).) Also, a number of U.S. tax treaties provide reciprocally that pensions and annuities received by a resident of one country from sources in the other are taxable only by the country of residence.

Reasons for change

The committee believes that a pension paid to a nonresident alien should be exempt from withholding where his country of residence has unilaterally by its internal law enacted a provision granting the same relief to U.S. citizens and residents. Also, the committee believes that employers should be encouraged to provide pensions for their employees in certain developing countries.

Explanation of provision

The provision would expand the statutory exemption from tax for pension annuities by making it available to an individual if (a) the country of residence of the individual grants a substantially equivalent exclusion to citizens and residents of the United States or (b) the recipient's country of residence is a "beneficiary developing country" under section 502 of the Trade Act of 1974.[1]

Effective date

The provision would apply to amounts received after July 1, 1979.

Revenue effect

It is estimated that this provision will decrease budget receipts by less than $5 million annually in fiscal years 1981 through 1985.

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[1] The following countries and territories are designated beneficiary developing countries for purposes of the Generalized System of Preferences, provided for in Title V of the Trade Act of 1974, 19 U.S.C. § 2461 *et seq.* (as designated in Executive Order No. 11888, November 24, 1975, as amended*):

Independent countries

Afghanistan, Angola, Argentina, Bahamas, Bahrain, Bangladesh, Barbados, Bhutan, Bolivia, Botswana, Brazil, Burma, Burundi, Cameroon, Cape Verde, Central African Empire, Chad, Chile, Colombia, Comoros, Congo, Costa Rica, Cyprus, Dahomey, Djibouti, Dominican Republic, Egypt, El Salvador, Equatorial Guinea, Ethiopia, Fiji, Gambia, Ghana, Grenada, Guatemala, Guinea, Guinea Bissau, Guyana, Haiti, Honduras, India, Israel, Ivory Coast, Jamaica, Jordan, Kenya, Korea, Republic of, Laos, Lebanon, Lesotho, Liberia, Malagasy Republic, Malawi, Malaysia, Maldives, Mali, Malta, Mauritania, Mauritius, Mexico, Morocco, Mozambique, Nauru, Nepal, Nicaragua, Niger, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Romania, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Singapore, Somalia, Sri Lanka, Sudan, Surinam, Swaziland, Syria, Taiwan, Tanzania, Thailand, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Upper Volta, Uruguay, Western Samoa, Yemen Arab Republic, Yugoslavia, Zaire, and Zambia.

Non-independent countries and territories

Antigua, Belize, Bermuda, British Indian Ocean Territory, British Solomon Islands, Brunei, Cayman Islands, Christmas Island, (Australia), Cocos (Keeling) Islands, Cook Islands, Dominica, Falkland Islands (Islas Malvinas), French Polynesia, Gibraltar, Gilbert and Ellice Islands, Heard Island and McDonald Islands, Kong Kong, Macao, Montserrat, Netherlands Antilles, New Caledonia, New Hebrides Condominium, Niue, Norfold Island, Pitcairn Islands, Saint Christopher-Nevis-Anguilla, Saint Helena, Saint Lucia, Saint Vincent, Tokelau Islands, Trust Territory of the Pacific Islands, Turks and Caicos Islands, Virgin Islands, British, Wallis and Futuna Islands, and Western Sahara.

*Executive Order No. 11888, Nov. 24, 1975, 40 F.R. 55276, as amended by Ex. Ord. No. 11906, Feb. 26, 1976, 41 F.R. 8758; Ex. Ord. No. 11934, Aug. 30, 1976, 41 F.R. 37084; Ex. Ord. No. 11960, Jan. 19, 1977, 42 F.R. 4317; Ex. Ord. No. 11974, Feb. 25, 1977, 42 F.R. 11230A; Ex. Ord. No. 12032, Dec. 27, 1977, 42 F.R. 64851; Ex. Ord. No. 12041, Feb. 25, 1978, 43 FR. 8099; Proc. No. 4561, Apr. 7, 1978, 43 F.R. 15127; Ex. Ord. No. 12104, Dec. 15, 1978, 43 F.R. 59053; Ex. Ord. No. 12124, Feb. 28, 1979, 44 F.R. 11729.

L. Election of Estate Tax Alternate Valuation (sec. 301 of the bill and sec. 2032 of the Code)

Present law

Under present law, the executor of a decedent's estate may value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," generally six months after the date of the decedent's death (Code sec. 2032). Alternate valuation provides estate tax relief when property in a decedent's state declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death or any period of extension granted by the Internal Revenue Service (Code sec. 2032(c)).

Under Code section 6081, the Internal Revenue Service may grant an extension of time to file an estate tax return. Except in the case of taypayers who are abroad, the Internal Revenue Service has no discretionary authority to grant an extension exceeding six months.

Reasons for change

The committee believes that alternate valuation should not be denied because an estate tax return is filed late. Alternate valuation is a substantive provision of the estate tax law, and its benefits should not be denied when a return is filed late. The procedural rules in the Internal Revenue Code currently provide for penalties in the case of late filing of an estate tax return and late payment of estate taxes.

Explanation of provision

The bill permits the election of alternate valuation on a timly filed estate tax return or the first late return filed. In the case of a timely filed return, an executor cannot change the election after the due date for the return has passed. In the case of a late return, the election cannot be changed after the first return has been filed.

Effective date

The provision applies to estates of decedents dying after December 31, 1980.

Revenue effect

This provision will have a negligible effect upon budget receipts.

M. Extension of Time To Amend Instruments of Charitable Split-Interests Trusts (sec. 302 of the bill and secs. 170, 2055, and 2522 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 noncharitable). 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 annually). These rules generally apply for estate and gift tax purposes with respect to decedents dying or transfers made after December 31, 1969, and for income tax purposes to contributions and transfers in trust after July 31, 1969. However, certain exceptions were provided in the case of wills executed, or property transferred in trust, on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills and revocable trusts until October 9, 1972 (unless the will was modified in the meantime), to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the Code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969 (which did not come within the statutory exceptions) to qualify for an income, estate, or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the governing instrument had to be amended was further extended by the Internal Revenue Service. On August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72–395, 1972–2 C.B. 340, which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under Code section 664.

In 1974, Congress extended the date by which the governing instrument of a trust created after July 31, 1969, and before September 21, 1974, or pursuant to a will executed before September 21, 1974, could be amended (P.L. 93–483). Under that Act, if the governing instrument was amended to conform by December 31, 1975, to meet the requirements of a charitable remainder annuity trust or unitrust or pooled income fund, an estate tax deduction was allowed for the charitable remainder interest which passed in trust from the decedent even though the interest failed to qualify at the time of the decedent's death.

The Tax Reform Act of 1976 extended to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, and before December 31, 1977, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The Act also extended the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977.

In the Revenue Act of 1978, Congress extended the amendment procedure to instruments establishing charitable lead trusts, and charitable remainder trusts in the case of income and gift taxes, which were created before December 31, 1977 (or created pursuant to a will executed before such date) which were amended (or judicial proceedings to amend were commenced) by December 31, 1978. As part of that provision, the Act extended until December 31, 1978, the time to amend (or to commence judicial proceedings to amend) instruments establishing charitable remainder trusts which were created before December 31, 1977 (or created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for estate tax purposes.

Reasons for change

Since the last extension enacted by Congress, a number of meritorious cases have come to the attention of the committee where amendment of the trust is the only method of preventing charity from bearing the additional estate taxes arising from the loss of the charitable deduction. In addition, the committee understands that the Treasury is studying the possibility of proposing a permanent rule on this issue. Consequently, the committee believes that an additional 3-year period, until December 31, 1981, is appropriate in order to permit the reformation of charitable split interest gifts.

Explanation of provision

The provision extends for 3 years (i.e., until December 31, 1981) the time to amend (or commence judicial proceedings to amend) instruments of both charitable lead trusts and charitable remainder trusts which were created before December 31, 1977 (or which were created pursuant to a will executed before such date) in order to conform such instruments to the requirements of the Tax Reform Act of 1969 for a charitable deduction to be allowed for income, gift, or estate tax purposes.

Effective date

The provision is effective, for estate and gift tax purposes, for decedents dying and transfers after December 31, 1969, and, for income tax purposes, for contributions and transfers in trust after July 31, 1969.

Revenue effect

It is estimated that the provision will decrease budget receipts by $16 million in fiscal year 1981, by $12 million in fiscal year 1982, by a negligible amount in 1983, and will not have any revenue effect thereafter.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 7956, as amended. The committee estimates that the bill will reduce budget receipts by $59 million in fiscal year 1981, $102 million in fiscal year 1982, $138 million in fiscal year 1983, $197 million in fiscal year 1984, and $271 million in fiscal year 1985.[1]

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new tax expenditures, but will increase existing tax expenditures by $52 million in fiscal year 1981, $99 million in 1982, $135 million in 1983, $194 million in 1984, and $268 million in 1985.

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 indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 7956, as amended, was ordered favorably reported by voice vote.

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[1] For budget scorekeeping purposes, the revenue effect figures estimated at less than $10 million have been counted as $5 million; those at less than $5 million at $3 million; those at less than $1 million at $500,000; and those estimated as negligible at $50,000.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the regulatory impact that might be incurred in carrying out the provisions of this bill, H.R. 7956, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation.—The bill does not regulate any individuals or businesses, but amends certain provisions of the tax law.

Impact on personal privacy.—The provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The provisions of the bill will not significantly affect paperwork burdens.

V. 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 paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, H.R. 7956, as reported by the committee).

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