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SENATE

{ REPORT
{ No. 96-1038

TREATMENT OF PUBLIC UTILITY PROPERTY UNDER SECTIONS 46(f) AND 167(l) OF THE INTERNAL REVENUE CODE OF 1954

REPORT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ON

H.R. 6806

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

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

REPORT

[To accompany H.R. 6806]

The Committee on Finance, to which was referred the act (H.R. 6806) to amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 regarding the treatment of public utility property and to provide a transitional rule with respect thereto, having considered the same, reports favorably thereon with amendments to the text and an amendment to the title 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. 6806, as it passed the House, clarifies the rules relating to the normalization requirements for public utility property eligible for the investment tax credit and accelerated depreciation. The bill also provides a special rule which, in general, excuses violations of these requirements for certain past periods where such violations were a result of certain orders entered by a public utility commission prior to March 13, 1980.

Committee bill.—The committee bill retains the provisions of the House bill, and the committee amended the bill to add the following provisions: (1) terminate retroactively a waiver of exemption for social security coverage filed by the Manhattan Bowery Corporation; (2) limit the amount treated as ordinary income on the sale of stock of certain foreign investment companies, and (3) provide that certain authors and artists are to be treated as employees of the New Yorker magazine for purposes of certain employee benefit provisions of the Internal Revenue Code.

I. SUMMARY

Section 1.—Treatment of Public Utility Property

The bill (H.R. 6806) clarifies the rules relating to the normalization requirements for public utility property eligible for the investment tax credit and accelerated depreciation. The bill also provides a special rule which, in general, excuses violations of these requirements for certain past periods where such violations were a result of certain orders entered by a public utility commission prior to March 13, 1980.

With certain exceptions for companies that are grandfathered, public utilities are eligible to use the investment credit and to elect accelerated depreciation for tax purposes only if the tax benefits from accelerated depreciation and the investment credit (or, in some cases, a portion of the credit) are normalized for ratemaking purposes. Normalization generally requires that the tax benefits of accelerated depreciation and the investment credit not be treated for ratemaking purposes as a reduction in current Federal income tax expense, which is an element of a utility's cost of service, since that treatment would generally result in a direct reduction in the utility's revenues. Instead, the tax benefits are to be treated as investment capital that is supplied, in effect, by the Federal government to the utility through the tax system. The normalization rules for accelerated depreciation require that the utility retain the use of the deferred taxes but permit the deferred taxes to be treated as zero-cost capital on which the utility need not be allowed to earn an investment return; the normalization rules for the investment credit require a similar allocation of benefits between utility shareholders and utility customers. The normalization rules relating to accelerated depreciation were imposed in 1969, and the normalization rules relating to the investment credit, for the most part, were imposed in 1971 and 1975.

The bill provides that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if such violations involved the use of estimates, projections, or rate of return adjustments (1) that applied for any period ending prior to March 1, 1980, and (2) that were included in certain orders of a public utility commission which were entered prior to March 13, 1980. This special rule is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

The bill amends the present normalization rules relating to accelerated depreciation and the investment tax credit to make it clear that certain ratemaking procedures involving the use of inconsistent

estimates or projections do not comply with such rules. It also gives the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking adjustments are inconsistent with normalization. The amendments to the normalization rules generally apply to taxable years beginning after December 31, 1979.

Section 2.—Termination of Waiver of Exemption from Social Taxes Filed by the Manhattan Bowery Corporation

Under present law, services performed for a nonprofit religious, charitable, educational, or other organization exempt from income tax are not covered by social security unless the organization waives its exemption from social security coverage. In general, the bill will terminate retroactively a waiver of exemption from social security coverage filed by the Manhattan Bowery Corporation of New York, New York.

Section 3.—Gain on Sale of Stock of Foreign Investment Company

Under present law, gain from the sale of stock of a corporation which at any time is a foreign investment company generally is treated as ordinary income to the extent of the selling shareholder's portion of the corporation's earnings and profits. Under the bill, gain attributable to earnings and profits for the period before the corporation became a foreign investment company will not be subject to this ordinary income treatment.

Section 4.—Treatment of Certain Authors and Artists as Employees for Purposes of Certain Employee Benefit Provisions

Under present law, an employer may currently deduct (within limits) the expense of providing certain fringe benefits to employees even though the benefit is not included in the gross income of the employees. The bill provides that certain authors and artists are to be considered employees for purposes of these benefits under limited circumstances.

II. EXPLANATION OF THE BILL

A. Treatment of Public Utility Property (sec. 1 of the bill and secs. 46(f) and 167(l) of the Code)

Present Law

Accelerated depreciation

In general

Accelerated methods of depreciation, i.e., methods of depreciation that are faster than straight-line depreciation over the useful life of an asset, were enacted in the Revenue Act of 1954 (Code sec. 167). Congress made this form of depreciation available because it believed that accelerated depreciation would increase investment in new equipment and processes.[1]

Accelerated depreciation for public utilities

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a reduction in current cost of service and therefore flowed through the resulting tax benefit to customers currently by reducing rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no direct investment incentive to public utilities.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), except for utilities with respect to which prior flow-through treatment for certain types of property was grandfathered, a utility could thereafter use accelerated depreciation for Federal tax purposes only (1) if the utility used a "normalization" method of accounting in its books of

[1] Subsequent congressional action with respect to depreciation generally has involved approval of a method to reduce the useful lives of assets so that depreciation may be calculated over a shorter period (such as the Asset Depreciation Range (ADR) system adopted in 1971 and various special 5-year amortization provisions). This is a different form of accelerated depreciation, but it tends to produce the same effect as a faster rate of depreciation in the calculations of a potential investor.

account and (2) if the regulatory agency used a normalization method of setting rates.[2]

Code section 167(l)(3)(G) provides that:

"In order to use a normalization method of accounting with respect to any public utility property—

> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
>
> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)–1(h)) have interpreted this section to require that: (1) a utility's tax expense for ratemaking purpose must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed using accelerated and using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from the rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of the cost of service. The Treasury Regulations (§ 1.167(a)–11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the temporary tax reductions from accelerated depreciation being retained by the utility as a source of cost-free capital for which the utility customers need not pay the utility an investment return.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: first, to assure that the deferred taxes resulting from accelerated depreciation would be available to the utilities as investment capital until paid to

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[2] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply mean the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;

(2) Gas or steam through a local distribution system;

(3) Telephone services;

(4) Other communication services (whether or not telephone services) if furnished or sold by the Communiactions Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or

(5) Transportation of gas or steam by pipeline,

if the rates for the furnishing or sale are established or approved by certain regulatory bodies.

the Treasury and, second, to avoid the possible loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce the taxable income of utilities.

Investment tax credit

In general

The investment tax credit was enacted initially in the Revenue Act of 1962 (generally at 7 percent, except as noted below for public utilities). In 1964, Congress repealed a provision in the 1962 Act which required that the basis for depreciation of eligible property be reduced by the amount of the credit. In 1966, the credit was suspended during a period of rapid investment growth, and the credit was restored in 1967 when the rate of investment growth subsided.

The investment credit was repealed as of April 18, 1969, in the Tax Reform Act of 1969, but was reenacted in the Revenue Act of 1971. In 1975, the investment credit was increased to 10 percent temporarily, and the 10-percent credit rate was made permanent in the Revenue Act of 1978.

The Energy Tax Act of 1978 enacted a 10-percent energy investment tax credit for various kinds of energy-related property. This credit was expanded, and increased to 15 percent in certain cases, in the Crude Oil Windfall Profit Tax Act of 1980.[3]

Investment tax credit for public utilities

Congress initially made a partial investment credit (3 percent instead of 7 percent) available to regulated public utilities. The reduced rate was a compromise between those who argued that utilities should be treated like other industries and those who argued that because the rates charged by regulated public utilities were intended to provide them with the opportunity to earn a satisfactory rate of return, they did not need Federal tax incentives to encourage capital investment.

In the Revenue Act of 1964, Congress provided that no Federal regulatory agency could flow through the tax saving from the investment credit to customers more rapidly than ratably over the useful life of the property. In addition, no Federal regulatory agency could require flow-through of any part of the credit in the case of any other property of a regulated company. Neither of these prohibitions would apply if the company consented.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services. (The 1971 Act also reduced the credit allowable to unregulated taxpayers to 4 percent for certain property used in competition with public utility property.)

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[3] Public utility property is not eligible for the energy investment credit except for small-scale hydroelectric property, equipment used to produce oil shale or gas from geopressured brine, and perhaps specially defined energy conserving property.

When Congress restored the investment credit in 1971, it generally provided that the investment credit would not be available to regulated public utilities unless the benefits of the credit were normalized under one of the two normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. (In the 1975 Act, the limit on the amount of tax liability offset by investment credits also was increased temporarily for most public utilities because low earnings and tax liabilities were leaving utilities with large amounts of unused credits to carry forward.) When the investment credit for public utility property was increased to 10 percent in 1975, it was provided that flow-through could not be utilized by these grandfathered utilities with respect to the additional 6 percent credit (or the additional credit allowable by reason of increased limitation based on tax liability) unless the company made a specific election. This rule was retained when the 10-percent rate was made permanent in 1978.

In general, present law (Code sec. 46(f)) denies the investment tax credit (both the regular credit and any allowable energy credits) with respect to public utility property if a public utility regulatory commission requires that the credit be immediately flowed through to customers or if the benefits of the utility's retention of the credit are not shared between utility customers and utility shareholders in a manner prescribed by one of the normalization options in the Code.

Under certain exceptions, however, the benefits of the investment tax credit may be flowed through immediately to customers if an election is made and if the taxpayer was on a flow-through method of accounting for depreciation purposes prior to 1969. As mentioned above, this immediate flow-through rule applies only to investment credit which would have been allowed under the rules in effect prior to 1975; the increase first provided with respect to public utility property in 1975 must be accounted for under a normalization method of accounting (Code secs. 46(f) (3) and (8)).[4]

Except for the special flow-through rules in the preceding paragraph, the investment credit is denied for public utility property if the ratemaking treatment of the credit results in the utility's shareholders receiving less than the benefit prescribed by (a) the ratable flow-through method or (b) the rate base reduction method, whichever is applicable.

Under the ratable flow-through method, the benefits of the investment credit may be shared with utility customers by passing through to them no more than a ratable portion of the investment credit during a period equal to the useful life of the asset that produced the credit. The ratable portion is equal in amount to the regulated depreciation allowance on that portion of the cost of the equipment paid for, in effect, by the credit. However, the utility shareholders must be allowed a return on the capital represented by the credit, just as with the

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[4] However, a public utility which had elected flow through prior to 1975 could make another election to flow through the additional credit. This additional election was structured so that it normally could be made by the company and not by direction of the regulatory commission.

Special rules are also provided to prevent flow through of the additional credit for contributions to an employee stock ownership plan (Code sec. 46(f) (9)).

private capital of the utility. In this manner, the benefits of the investment credit are shared by passing through to customers the equivalent of the depreciation allowance on the portion of the purchase price of the property paid for by the credit and by requiring that the utility earn a return on the investment that, in effect, has been supplied by the credit.

Under the rate base reduction method, the utility's rate base is reduced by the amount of the credit, so that the shareholders are prevented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. However, under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment including the part paid for by the investment credit.

Reasons for Change

Accelerated depreciation methods and the investment tax credit were enacted in order to encourage higher rates of investment in plant and equipment. This result is achieved by increasing the estimated rate of return after taxes over the life of the asset involved through reducing the initial cost of the investment or making possible a more rapid recovery of the funds invested in capital assets.

When it considered the Tax Reform Act of 1969, Congress found that public utility regulatory agencies were adopting very different methods of flowing through to customers the tax benefit from accelerated depreciation. About half the regulatory agencies required utilities that use accelerated depreciation to flow through the tax reduction from accelerated depreciation immediately in the form of lower rates. Some agencies insisted that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, treated the utilities as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have used straight-line depreciation on their tax returns. Other agencies permitted the utilities under their jurisdiction to normalize the deferred tax liabilities resulting from accelerated depreciation (i.e., permit the company to retain the temporary tax savings but pass through to cutsomers the resulting cost of capital savings). The trend, however, appeared to be towards use of immediate flow-through. As a result, Congress decided, as part of the Tax Reform Act of 1969, essentially to freeze the then current situation with regard to the circumstances under which accelerated depreciation methods could be used by a regulated public utility.

The freeze applied to existing property as of August 1, 1969. It permitted most flow-through practices to continue, but provided that subsequent changes to a faster rate of depreciation for Federal income tax purposes would not be allowed.

For new (i.e., post 1969) property, a public utility generally was allowed to flow through the tax benefits from accelerated depreciation if that was the practice as of August 1, 1969. In all other cases, straight-line depreciation was required unless the tax benefits from accelerated depreciation were normalized.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the increased credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services.

When Congress restored the investment credit in 1971, it provided that the investment credit would not be available in cases where the credit was immediately flowed through to customers or where some of the benefits of the utility's retention of the credit were not retained by the utility as provided under one of the normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. When the investment credit for public utility property was increased to 10 percent in 1975, it was provided that, for the most part, flow through could not be utilized by these grandfathered utilities with respect to the additional 6 percent unless the company made an election. This rule was retained when the 10-percent rate was made permanent in 1978.

Considerable controversy has arisen over the proper application of these normalization rules, principally in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected, and it flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including 3 more decisions of the California Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers. Although no final determination has been made as to whether these methods comply with the Code's normalization require-

ments, the Internal Revenue Service has issued private rulings which take the position that the methods do not comply with such requirements. As a result, these telephone companies are faced with a situation in which they may be deemed ineligibile to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which is subject to the "anti-flow-through" rules of the 1975 Act.

The committee believes that it is desirable to clarify for the future the rules relating to normalization so that no further disputes of the type which has occurred in California will arise. The committee also believes that it is appropriate to provide a special rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used accounting methods which were prescribed by an order of a public utility commission entered prior to March 13, 1980. This special rule is designed to meet a specific, one-time problem which has arisen as a result of a misapplication of the normalization rules in certain California cases. The committee remains convinced that the normalization rules provided in the Code are appropriate for public utilities and does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief in subsequent incidents. This is particulary true because the committee believes that it is generally inappropriate for Federal tax incentives designed to encourage investment to be used to subsidize utility rates.[5]

Explanation of provision

The bill contains two amendments to the normalization rules which do not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, and designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

1. Accelerated depreciation

The bill adds a new provision (Code sec. 167(l)(3)(H)) which clarifies the present definition of the normalization method of accounting (in Code sec. 167(l)(3)(G)) for accelerated depreciation in a manner which generally follows the interpretion of this provision now contained in Treasury regulations.

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[5] Some evidence of the effect of flowthrough ratemaking on utility rates may be derived from information supplied to the Ways and Means Committee by John E. Bryson, President of the California Public Utilities Commission, by letter dated May 12, 1980. Data contained in Mr. Bryson's letter indicated that, for the 22 major metropolitan areas outside of California, residential monthly local exchange rates range from $11.95 (in Cleveland) to $6.45 (in Chicago) as of June 1, 1979, but the residential monthly local exchange rate for the San Diego, San Francisco, and Los Angeles areas was $5.70. Mr. Bryson further indicates that compliance with the normalization rules, as clarified by the bill, would probably result in approximately a 6-percent increase in local service charges.

This added provision generally provides that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury is also given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "AAA" method, and any other similar method, of making adjustments for ratemaking purposes does not comply with the normalization requirements of Code section 167 (l) (3) (G).

2. *Investment tax credit*

The bill adds a new provision (Code sec. 46(f) (10)) to the rules relating to normalization of the investment tax credit. The new provision generally provides that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment tax credit unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The Treasury Department also is given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method or the ratable flow-through method. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "AA" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provisions added by the bill (new Code secs. 46(f) (10) and 167(l) (3) (H)) specify only one manner in which the normalization rules may be violated. Thus, compliance with these provisions is a necessary but not sufficient condition for eligibility for the investment tax credit and accelerated depreciation.

3. *Special rule for periods prior to March 1, 1980*

The bill provides that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections, or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order. For purposes of this special rule, a qualified order is an order of a public utility

commission—(1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule applies to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

Effective Date

These provisions—other than the special rule—generally apply to taxable years beginning after December 31, 1979. However, these provisions can be overridden by the special rule for periods prior to March 1, 1980.

The bill explicitly provides that, in applying the normalization rules (Code secs. 46(f) and 167(l)(3)) to taxable years beginning before January 1, 1980, no inference shall be drawn from the amendments to these rules (new Code secs. 46(f)(10) and 167(l)(3)(H)) or from the special rule. However, this no inference rule is not intended to limit the relief provided by the special rule.

The bill also provides that no refund or credit of any overpayment of tax attributable to the special rule may be made or allowed prior to October 1, 1981.

Revenue Effect

It is estimated that the permanent changes made by these provisions will have no revenue effect.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980, to the three utilities which would be benefited by the special rule do *not* comply with the current normalization rules in the Code, the special rule in the bill will result in a revenue loss of approximately $1.85 billion attributable to accounting periods prior to March 1, 1980. Approximately $110 million of this amount has been paid into the Treasury and could be the subject of claim for a refund which could be filed at any time through February 1982. Since the bill provides that no refund or credit of any overpayment of tax attributable to the provisions of the bill may be made or allowed prior to October 1, 1981, the $110 million of revenue loss would probably occur in fiscal year 1982. The remainder of the $1.85 billion revenue loss generally would occur in the fiscal year or years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1981.

If these orders do comply with the current normalization rules, the special rule in the bill would result in no revenue loss as long as orders in effect for periods after March 1, 1980, are in compliance with the revised normalization rules.

B. Termination of Waiver of Exemption from Social Security Taxes Filed by the Manhattan Bowery Corporation (sec. 2 of the bill)

Present law

Under present law, services performed for a nonprofit religious, charitable, educational, or other organization exempt from income tax under section 501(a) of the Code as an organization described in section 501(c)(3) of the Code are not covered by social security. However, an organization may waive its exemption from employment taxes by filing a waiver certificate (Form SS–15) with the Internal Revenue Service certifying that it desires to have social security coverage extended to the services performed by its employees (Code secs. 3121(b)(8) and 3121(k)(1)).

A waiver of exemption from social security coverage (provided by section 3121(k)(1) of the Code) may be terminated if the organization which has waived its exemption gives two years' advance notice in writing (Code sec. 3121(k)(1)(D)). However, an organization may not terminate its waiver of exemption in this manner unless it has had a waiver in effect for a period of at least 8 years.

Background

The Manhattan Bowery Corporation, a tax-exempt organization, was incorporated under the laws of the State of New York on October 27, 1967. Since its inception, the Corporation has been withholding social security taxes from its employees' wages and has been paying these taxes, along with the employer's share of social security taxes, to the Internal Revenue Service.

In 1974, the Corporation became concerned that it might not have filed a waiver certificate (Form SS–15) waiving its exemption from social security coverage. Accordingly, the Corporation asked the IRS to waive the statutory requirements with respect to the filing of a certificate for waiver of exemption and to credit present and former employees' accounts for all quarters for which social security taxes had been paid. The IRS then informed the Corporation that the Social Security Administration would only adjust or revise earnings records for a limited period of time (i.e., no more than 3 years, 3 months, and 15 days preceding the receipt of a notice of error) and that an SS–15 could be filed with an effective date 5 years subsequent to the date of filing. The IRS also pointed out that all present and former employees of the Corporation would be entitled to make an election as to whether or not they would concur with the filing of an SS–15 (that is, whether or not they wanted social security coverage). The employees who elected not to concur would be entitled to a refund of social security taxes previously withheld, subject to a three-year statute of limitations on the period for which a refund could be granted. Likewise, the Corporation would be entitled to a refund for the employer's share

of social security taxes. Furthermore, those employees who received refunds of social security taxes previously withheld also could elect not to have social security taxes withheld from future wages, thereby foregoing the benefits of social security coverage.

On March 31, 1975, the Corporation filed a Form SS–15 with an effective date of April 1, 1970. Many of the Corporation's current and former employees elected to receive refunds of previously paid social security taxes and some of the Corporation's current employees elected to forego social security coverage for future years.

Between March 31, 1975, when the Form SS–15 was filed, and June 30, 1977, the Corporation did not withhold the employees' portion of social security taxes from those employees who elected not to be covered by social security nor did it contribute the employer's portion of social security taxes with respect to wages paid to those employees.

In March 1977, the Corporation found out that it had, in fact, previously filed a Form SS–15, with an effective date of October 1967. The IRS, therefore, reassessed the social security taxes which had been refunded (except those for the years 1971 and 1972) and demanded repayment of those taxes, along with interest and penalties, as of August 2, 1977. The IRS also assessed the Corporation for social security taxes not collected between April 1, 1975 and June 30, 1977.

The IRS has filed a lien against the Corporation and has informed the Corporation that in the event it is unable to collect the amount of social security taxes due, it may assess a penalty of 100 percent of the uncollected taxes against the officers and directors of the Corporation.

Reasons for change

The Manhattan Bowery Corporation has been confronted with substantial tax deficiencies because it was unaware that a waiver of exemption from social security coverage had been in effect since its inception. Actions taken by the Corporation, which have resulted in these tax deficiencies, were based upon the erroneous assumption that a waiver of exemption had not been filed. In fact, when the Corporation first became concerned that it may not have filed a waiver, the IRS made no mention that a waiver might previously have been filed. It was not until 1977 that the Corporation discovered that a waiver had been in effect since its inception.

Because the Corporation has made every good faith effort to comply with the law, the committee believes that it should be granted relief by being permitted to terminate retroactively its waiver of exemption from social security coverage.

Explanation of provisions

Subject to certain conditions, the bill terminates retroactively the certificate for waiver of exemption from social security coverage filed by the Manhattan Bowery Corporation.

Under the bill, the waiver of exemption of the Manhattan Bowery Corporation is deemed not to be effective, for purposes of the portion of social security taxes imposed upon an employee (Code sec. 3101), with respect to wages paid by the Corporation to an employee after December 31, 1972, and prior to April 1, 1975, if the Corporation furnishes to the Secretary of the Treasury evidence that it has re-

funded, prior to February 1, 1977, to such employee (or to his survivors or estate) the full amount of the employee's portion of social security taxes imposed on such wages. In addition, the waiver is deemed not to be effective, for purposes of the portion of social security taxes imposed upon an employee, with respect to wages paid by the Corporation to an individual as an employee after March 31, 1975, and prior to July 1, 1977, if the Corporation furnishes to the Secretary evidence that such individual was not an employee of the Corporation on June 30, 1978, and that no amount of the employee's portion of social security taxes on such wages were withheld by the Corporation.

Once the provisions of the bill become effective with respect to any wages paid by the Corporation to an employee, none of the taxes imposed upon those wages by section 3101 of the Code (employee's portion of social security taxes) will be payable. In addition, no interest or penalty with respect to the imposition of taxes by sections 3101 or 3111 (employer's portion of social security taxes) of the Code on any wages paid by the Corporation prior to January 1, 1978, will be imposed or collected.

The bill provides that, in the administration of titles II (Federal Old-Age, Survivors, and Disability Insurance Benefits) and XVIII (Health Insurance for the Aged and Disabled) of the Social Security Act, wages to which the bill applies will be treated as wages for purposes of determining entitlement to, or amount of, any insurance benefit payable on the basis of wages and self-employment income, or entitlement to benefits under title XVIII of the Social Security Act on the basis of wages and self-employment income. The relief provided by the bill is available only to a "qualified corporation." A qualified corporation is any corporation which: (1) filed a certificate for waiver of exemption from social security coverage during 1968; (2) filed a second waiver certificate during 1975 under the belief that no other waiver certificate had been filed; (3) received a refund of social security taxes, with respect to certain wages paid to more than 120 but less than 180 employees who did not concur in the filing of the second waiver certificate; and (4) was notified during 1977 by the Internal Revenue Service that a certificate had been filed during 1968. In addition, the relief provided by the bill does not relieve any corporation of any liability for the payment of taxes imposed by section 3111 of the Code with respect to any wages paid by it to any individual for any period.

The bill provides that the Secretary of the Treasury is to credit to a qualified corporation an amount equal to the sum of: (1) the employees' portion of social security taxes with respect to wages paid to employees after December 31, 1972, and prior to April 1, 1975, to the extent that those taxes have been refunded prior to February 1, 1977, and (2) penalties and interest paid with respect to social security taxes on certain wages paid between December 31, 1972 and July 1, 1977.

Effective date

The provisions of the bill relating to wages paid to any employee after December 31, 1972, and prior to April 1, 1975, will not become effective unless, prior to the close of the one-year period beginning on

the date of enactment, the Corporation furnishes to the Secretary of the Treasury evidence that it has refunded to such employee the full amount of taxes imposed by section 3101.

The provisions of the bill relating to wages paid to an individual as an employee of the Corporation after March 31, 1975, and prior to July 1, 1977, will not become effective unless, prior to the one-year period beginning on the date of enactment, the Corporation furnishes to the Secretary of the Treasury evidence that such individual was not an employee of the Corporation on June 30, 1978, and that no taxes under section 3101 of the Code were withheld from wages paid to such individual.

Revenue effect

The Internal Revenue Service has assessed deficiencies totaling $182,914.96. This bill will reduce the deficiency assessment by $91,457.88, which is the sum of three components. The first component is the employee share of contributions under Code section 3101 between December 31, 1972 and April 1, 1975. Second, for individuals not employed by the taxpayer on June 30, 1978, the bill waives the employee share of contributions, between March 31, 1975 and July 1, 1977. Lastly, the bill waives interest and penalties with respect to social security contributions due for these periods from both employees and the employer.

C. Gain on Sale of Stock of Foreign Investment Company (sec. 3 of the bill and sec. 1246 of the Code)

Present law

In general, gain on the sale of stock in a foreign corporation which is a foreign investment company is treated as ordinary income to the extent of the selling shareholder's portion of its earnings and profits. A foreign investment company is defined as any foreign corporation controlled by U.S. persons which is registered under the Investment Company Act of 1940 or which engages in certain investment activities specified in that Act.

Ordinary income treatment applies to the extent of the earnings and profits attributable to the period of time (after 1962) during which the stock was held by the selling shareholder (even if the corporation was a foreign investment company for only part of that period). Thus, for example, the U.S. shareholders of a foreign corporation which was organized in 1963, which engaged in activities which made it a foreign investment company for only one year, say, 1970, and which liquidated in 1980, would be taxed under section 1246 as though the corporation were a foreign investment company for the entire 17 years rather than just the one year.

Reasons for change

Since the special rules for ordinary income on the sale of stock of a foreign investment company were not intended to apply to earnings and profits attributable to a period in which the company was not a foreign investment company, the committee believes that gain from the sale of stock in a foreign corporation attributable to earnings and profits from the period before the corporation became a foreign investment company should not be treated as ordinary income under these rules.

Explanation of provision

The bill provides that gain on the sale of a foreign corporation's stock will not be taxed under Code section 1246 with respect to earnings and profits of the corporation attributable to years before the corporation is a foreign investment company. This treatment prevents gain attributable to active business operations from being taxed under the foreign investment company provisions if the corporation subsequently becomes a foreign investment company. In most cases, this would result in treatment of the gain as capital gain. However, if the corporation has been a controlled foreign corporation, part of the gain might be treated as a dividend (Code sec. 1248).

Effective date

The provision applies to sales or exchanges after the date of enactment of the bill in taxable years ending after that date.

Revenue effect

It is estimated that this provision will reduce budget receipts by $5 million in fiscal year 1981 and by less than $1 million annually in later years.

D. Treatment of Authors and Artists as Employees for Certain Purposes of the Code (sec. 4 of the bill)

Present law

Under present law, authors and artists and other individuals who are not considered to be employees are not entitled to be considered employees for purposes of certain employee benefit provisions of the Code (secs. 79, 101(b), 104, 105, and 106), and are not entitled to participate in employer-sponsored pension, profit-sharing, stock bonus, or annuity plans.

Group-term life insurance exclusion

Section 79 generally excludes from the gross income of an employee the cost of up to $50,000 of employer-provided group-term life insurance.

Death benefit exclusion

Under section 101(b), gross income does not include amounts of up to $5,000 received by the beneficiaries or by the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee.

Exclusion for compensation for injuries or sickness

Section 104 provides, in pertinent part, that gross income does not include amounts received under workmen's compensation acts as compensation for personal injuries or sickness, or amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee that are attributable to contributions by the employer which were not includible in the gross income of the employee, or amounts that are paid by the employer).

Amounts received under accident and health plans

General.—Under section 105, amounts received by an employee through accident or health insurance for personal injuries or sickness generally are includible in gross income to the extent such amounts are attributable to contributions by the employer, which were not includible in the gross income of the employee, or are paid by the employer. However, such amounts are not generally includible in gross income if they are paid to an employee as reimbursement for expenses incurred for the medical care of the employee, or the employee's spouse or dependents. In addition, gross income does not include amounts received by an employee through accident or health insurance to the extent such amounts constitute payment for the permanent loss of use of a member or function of the body or for the permanent disfigurement of the employee, or the employee's spouse or dependent, and are

computed without regard to the period the employee is absent from work.

Certain disability payments.—Under section 105(d), amounts received by an employee through employer-provided accident or health insurance for personal injuries or sickness are not includible in gross income if the taxpayer has not attained age 65 before the close of the taxable year, has retired on disability and, upon retirement, was permanently and totally disabled. In addition, such amounts must constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of permanent and total disability. The maximum exclusion provided by section 105(d) is $100 per week (for a maximum of $5,200 annually). If the taxpayer's adjusted gross income for the taxable year (determined without regard to section 105(d) exceeds $15,000, the amount excludible is reduced on a dollar-for-dollar basis by an amount equal to the excess of adjusted gross income over $15,000. Thus, the exclusion is phased-out entirely for adjusted gross income of $20,200 and above. In order to take advantage of the section 105(d) exclusion, a married couple must file a joint return.

Self-insured medical reimbursement plans.—Under section 105(h), self-insured medical reimbursement plans are subject to rules regarding discrimination as to eligibility and benefits in favor of employees who are officers, shareholders, or highly compensated. Reimbursements to an officer, etc., under a discriminatory plan are wholly or partly includible in income.

Employer contributions to accidents and health plans

Section 106 provides that gross income does not include contributions by an employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness.

Employer contributions to pension, etc., plans

Employer contributions to qualified pension and other plans generally are deductible by the employer and generally are not taxed as income to the employee until the plan benefits are paid. In addition, the tax on the investment income of the pension plan is generally deferred until the benefits are paid. Also, estate and gift tax exclusions are provided. There are similar tax provisions relating to self-employed individuals (Keogh plans), employees of schools and tax-exempt organizations (tax-sheltered annuities), and individuals not covered by qualified plans or annuities (individual retirement accounts and annuities).

Reasons for change

The committee believes that authors and artists who are under contract with the *New Yorker* magazine and who have been considered employees under the pension, profit-sharing, and annuity plans of that magazine should be considered as employees for purposes of the employee benefit provisions.

Explanation of provision

Under the bill, authors and artists are considered to be employees of a corporation for purposes of certain employee benefit provisions of the Code [6] under limited circumstances.

The bill provides that an individual who is an author or artist under contract with a corporation is treated as an employee of the corporation for taxable years beginning after December 31, 1980, if (1) the individual was, on December 31, 1977, a participant in one or more of the pension, profit-sharing, or annuity plans of the corporation, (2) the contract is a "first refusal" or "best efforts" contract and (3) the corporation meets requirements specified in the bill.

A corporation meets the requirements of the bill if, for at least 15 years before January 1, 1978, it had in effect one or more pension, profit-sharing, and annuity plans, each of which contained, from the plan's inception, a definition of the term "employee" that included the category of "authors and artists under contract", and if each of the plans had been determined by the Secretary of the Treasury (with such definition) to be a qualified plan for purposes of the Code.

This provision is intended to benefit certain authors and artists under contract with the *New Yorker* magazine.

Effective date

The provision applies to taxable years ending after December 31, 1980.

Revenue effect

This provision will have a negligible effect upon budget receipts.

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[6] The authors and artists are considered employees for purposes of (1) section 79, with respect to group-term life insurance purchased for employees; (2) sections 104, 105, and 106, with respect to accident and health insurance or accident and health plans; (3) section 101(b), with respect to employees' death benefits; and (4) the income tax rules relating to contributions and distributions to or under a stock bonus, pension, profit-sharing, or annuity plan or a trust forming a part of such a plan.

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. 6806, as amended. The committee estimates that the bill will reduce budget receipts by $5 million in fiscal year 1981, $111 million in fiscal year 1982, and $436 million in each of the next three fiscal years.[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 or increased tax expenditures.

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. 6806, 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 $1 million have been counted as $500,000; and those estimated as negligible as $50,000.

IV. REGULATORY IMPACT TO 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. 6806, 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. The bill clarifies the rules relating to the normalization requirements for public utility property eligible for the investment tax credit and accelerated depreciation, terminates retroactively a waiver of exemption for social security coverage filed by the Manhattan Bowery Corporation, limits the amount treated as ordinary income on the sale of stock of certain foreign investment companies, and provides that certain authors and artists are to be treated as employees of the New Yorker magazine for purposes of certain employee benefit provisions of the Internal Revenue Code.

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 have a significant impact on 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. 6806, as reported by the committee).

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