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# CERTAIN ASSESSMENTS FOR DEPRECIABLE PROPERTY

AUGUST 1, 1968.—Ordered to be printed

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

## REPORT

[To accompany H.R. 2767]

The Committee on Finance, to which was referred the bill (H.R. 2767) to amend the Internal Revenue Code of 1954 to allow a farmer an amortized deduction from gross income for assessments for depreciable property levied by soil or water conservation or drainage districts, having considered the same, reports favorably thereon with amendments and recommends that the bill, as amended, do pass.

## I. SUMMARY

*Bill passed by House.*—The bill as passed by the House provides that if a farmer pays an assessment levied by a soil or water conservation or drainage district which is attributable to the acquisition by the district of depreciable property, the amount paid can be deducted for income tax purposes on an amortized basis over a 10-year period. However, if the taxpayer's share of the assessment for the depreciable asset is more than 10 percent of the total amount assessed against all members, his deduction is limited to 10 percent of the total assessment. The provision applies only to assessments levied after the date of the enactment of the bill.

The committee amended the provision so that it is not necessary in every case to take the deduction on an amortized basis over a 10-year period. Under the committee amendment the entire amount paid during the taxable year for an assessment attributable to the purchase of depreciable property is to be deductible in that year if the amount paid is not in excess of 10 percent of the aggregate amounts which have and will be assessed as the taxpayer's share of the cost to the district of such property. Moreover, even if the amount paid is in excess of this 10-percent figure, the entire amount may still be deducted when

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paid, if this excess amount is not over $500. In those cases where the amount paid both is in excess of this 10-percent figure and is over $500, then the excess must be deducted ratably over the 9 succeeding taxable years. The committee amendment also provides that if the land with respect to which the assessments were made is sold by the taxpayer during the 9-year period, any amount of the assessment paid which was not deductible before the sale because of the 9-year rule shall be added to the basis of the land in computing the gain or loss on its sale and thereafter may not be deducted.

*Provisions added by committee.*—The committee also added the following provisions to the House bill:

*Pension Plans.*—An amendment that qualified pension plans under the tax laws (or retirement practices) which provide for a reasonable differentiation in retirement ages between male and female employees or which has reasonable retirement age provisions are not to be construed as violating laws which prohibit discrimination in employment practices because of sex or age.

An amendment which authorizes the Treasury Department to treat as qualified pension plans for tax purposes union negotiated pension plans entered into between union representatives and a single employer if the Treasury Department determines that the plans presently meet all requirements of law, that no disbursements in past years were made contrary to the provisions of law, and that contributions to such plans were not used in a manner which would jeopardize the interests of the beneficiaries. (This treatment is presently available for multiemployer plans; the amendment extends this to single-employer pension plans.)

*Tax-Exempt Organizations; Charitable Trusts.*—An amendment which provides that the provisions of existing law denying tax-exempt status to otherwise tax-exempt organizations and denying unlimited charitable contributions deductions for trusts because of an unreasonable accumulation of income is not to apply in the case of income from property transferred to trusts before 1951 if the trusts were irrevocable at that time and income under the terms of the trusts was required to be accumulated (present law contains a similar provision limited to testamentary trusts created before 1951).

An amendment which provides that the Treasury regulations, holding that certain advertising income of exempt organizations from periodicals they publish constitutes unrelated business income subject to the unrelated business income tax, are to be postponed for 1 year so that they will first take effect with respect to taxable years beginning after December 12, 1968.

*Insurance Companies.*—An amendment which provides that the so-called "phase III" tax applicable generally to life insurance companies is not to apply in certain cases where a life insurance company distributes the stock of a 100 percent owned subsidiary to a holding company which owns 100 percent of its stock. However, in such cases the so-called "phase III" tax is to apply when the former subsidiary thereafter makes distributions (or when the holding company sells the stock of the subsidiary) in the same manner as if such distributions or sales constituted distributions by the life insurance company.

An amendment which provides for loss carryovers where one type of insurance company is converted into another type (where a stock casualty insurance company becomes a mutual casualty insurance

company or a life insurance company, or vice versa). In these cases the loss deduction available is to be limited to the loss carryover computed under the rules applicable to the company before its change in status or after its change in status, whichever results in the smaller loss carryover.

*Regulated Investment Companies.*—An amendment which provides that so-called development companies (established to provide funds for corporations marketing new products) which are taxed as regulated investment companies (mutual funds) must dispose of their excess holdings in such corporations within a 20-year period (instead of the 10-year period under present law) to the extent the holdings represent more than 25 percent of their investments. However, for this treatment to be available beginning with the fifteenth year such companies must dispose of at least 40 percent of their excess holdings of stock by the end of the 15th year. Companies which once met the statutory requirements to qualify as regulated investment companies through the application of the special development company rules, and which fail to meet these limitations for any quarter, may not have the benefit for that quarter of a savings clause which under existing law applies to regulated investment companies.

## II. THE BILL PASSED BY THE HOUSE

*Reasons for provisions.*—Under the existing law (sec. 175 of the code), a farmer can elect to deduct certain capital expenditures he incurs for the purpose of soil or water conservation. He can deduct expenditures paid for such items as grading and terracing, contour furrowing, the digging of drainage or irrigation ditches, the construction of diversion channels, earthen dams, watercourses, ponds, etc. However, he cannot deduct the cost of acquiring or constructing for soil or water conservation purposes any machinery or other facility which is subject to the allowance for depreciation. In the case of depreciable items such as irrigation pumps, or concrete ditches or concrete dams, the farmer is allowed deductions only through the depreciation allowances and only if he owns the asset (under sec. 167).

The deduction for soil and water conservation expenditures (under sec. 175) is limited in any one year to 25 percent of the gross income derived by the taxpayer from farming. Any excess amount is carried forward to succeeding taxable years.

Existing law also provides (sec. 175(c)(1)) that a farmer can deduct his payment of an assessment levied by a soil or water conservation or drainage district to the extent that the assessment covers expenditures made by the district which the taxpayer could have deducted if he had incurred them himself. Thus, if the assessment is for digging an irrigation or drainage ditch, the assessment paid by the farmer is deductible. But if part of the assessment covers the cost of acquiring depreciable property by the district, that part is not deductible since a farmer could not himself deduct (except through depreciation allowances) the cost of acquiring depreciable property. Since farmers cannot take depreciation deductions on depreciable assets owned by the district (even though paid for by the farmers through assessments) the result is that the farmer in a soil or water conservation district is treated less favorably from a tax standpoint than the farmer who undertakes soil and water conservation activities for himself.

The committee agrees with the House that when an assessment is levied by a soil or water conservation or drainage district to cover the cost of acquisition by the district of depreciable property in connection with soil or water conservation, the farmer should be allowed to deduct the amount paid in a manner which is roughly comparable to what is allowed through depreciation deductions when the farmer himself buys machinery or other depreciable property used for soil or water conservation purposes.

Accordingly, the House bill provided that a farmer is to be allowed a deduction on an amortized basis over a 10-year period when depreciable property is acquired by the district and a single assessment is made to cover the cost of the property. While the committee is in general agreement with the House in this matter, in some cases it is not necessary to require, as did the House bill, that every assessment paid must be deducted on an amortized basis. For example, a district might borrow money to construct a concrete dam and the loan will be retired by making 10 or more equal annual assessments against the members. In such a case it is not necessary, in order to provide a deduction roughly comparable to depreciation allowances, that each assessment paid be deducted on an amortized basis, and under the provision as amended by the committee each assessment in such a case would be deductible in full in the year paid. If less than 10 assessments were levied to retire the loan, then the farmer's deduction for payment of each assessment would be generally limited to 10 percent of his share of the cost of constructing the dam, and the excess of each assessment over the 10-percent figure would be deductible on a ratable basis over the succeeding 9 taxable years.

*Explanation of provision.*—The bill amends section 175 of the code to permit an individual farmer to deduct that portion of an assessment against him by a soil or water conservation or drainage district for property of a character subject to an allowance for depreciation. This depreciable property includes pumps, locks, concrete structures, such as dams and weir gates, draglines, and similar equipment. However, the depreciable equipment must be used in the district's activity as such. As a result, no deduction is allowed for an assessment by a district if the proceeds are used to purchase or construct depreciable equipment for use in some activity other than soil or water conservation or drainage activities.

Under present law, the term "soil or water conservation or drainage district" includes nonprofit mutual irrigation companies which are exempt from tax under the provisions of section 501(c)(12) of the code, as well as soil and water conservation districts, drainage districts, irrigation districts, watershed improvement districts, flood control districts, and conservancy districts. No change in this interpretation is intended. Thus, the term "soil or water conservation or drainage activities" includes activities undertaken by these companies or districts for the purpose of furnishing water to farmland, controlling farm water, or drainage of water from farmland. The term "soil or water conservation or drainage district" does not include irrigation or drainage companies operated for profit.

The amount which may be deducted by any one taxpayer under this provision may not exceed 10 percent of the total amount of the assessment by the district which is attributable to the acquisition of de-

preciable assets. Thus, for example, if an assessment by a district against its members in the total amount of $1 million includes $100,000 which is attributable to the acquisition by the district of depreciable assets, no one taxpayer may deduct a total of more than $10,000 under this provision. To the extent that an assessment against a taxpayer exceeds the 10-percent limit, the excess is a capital expenditure which must be added to the basis of the farm property involved. If an assessment which exceeds the 10-percent limit is payable in installments, each installment is to be divided between a deductible portion and a capitalized portion.

The bill as amended by the committee also provides that if the amount of the assessment paid (attributable to the acquisition of depreciable property by the district) is in excess of an amount equal to 10 percent of the aggregate amounts which have and will be assessed against the taxpayer as his share of the cost to the district in acquiring the depreciable property, and the amount in excess of the 10 percent in any year is over $500, then this excess is not to be deductible in the year paid but instead is to be deductible ratably over each of the 9 succeeding taxable years. Where the amount which otherwise would have to be spread amounts to $500 or less, the full amount is allowed as a deduction in the year of payment so that amortization is not necessary where the amounts involved are relatively small. Thus, if the district acquires a machine and makes only one assessment against its members to pay for the machine, only 10 percent of the assessment would be deductible in the year when paid by the farmer (assuming the remaining 90 percent represents more than $500) and the remaining 90 percent would be deductible ratably over the following 9 taxable years.

However, if the district borrows money to buy the machine and more than one assessment will be made against the members to retire the loan, then each assessment paid is deductible to the extent it does not exceed 10 percent of the total assessments that will be made against the taxpayer's land as its share of the cost of acquiring the machine. For example, if an initial assessment of $900 is paid by a farmer on account of the acquisition of depreciable property by the district, and $1,800 more (excluding interest) will be assessed against him in subsequent years to make up his share ($2,700) of the cost to the district of acquiring such property, only $270 of the initial $900 assessment (10 percent of $2,700) can be deducted in the year paid, and the balance of $630 would be treated as paid or incurred ratably over the succeeding 9 taxable years. Any subsequent assessment not over $770 (on account of the acquisition of such property) would be deductible when paid. If any subsequent assessment is over $770, $270 would be deductible in the year of payment and the balance would be treated as paid ratably over the succeeding 9 taxable years. If the subsequent assessments were $770 or less, the entire amount could be deducted when paid since the excess over the $270 which normally could be deducted in the year paid is not over $500.

Where a series of annual assessments are levied against a tract of land to pay for depreciable property acquired by the district, and a taxpayer buys the tract after some of the assessments have already been levied and paid by the prior owner, the prior assessments are to be taken into account in computing the aggregate amounts which have

been and will be assessed against the land as its share of the cost of the depreciable property acquired by the district.

The provision as amended by the committee also deals with the situation where part of an assessment paid by a farmer is required to be deducted on a ratable basis over 9 years, and the farmer sells or otherwise disposes of the land (other than by his death) before the expiration of the 9-year period. In such a case the amount of the assessment which has not been treated as paid or incurred prior to the sale or other disposition of the land is added to the adjusted basis of the land immediately prior to its disposition, and the amount so added to basis is not thereafter deductible. If a taxpayer dies in the 9-year period, any amount not previously deducted may (subject to the 25-percent rule applicable to soil and water conservation expenditures) be deducted in the year of death.

If an individual is unable (by reason of the 25-percent limitation in sec. 175(b) of the code) to deduct all of his soil or water conservation expenses in a given year, section 175(b) of present law provides that the unused deduction may be claimed in succeeding taxable years in order of time, subject to the limitations in that section. This same rule applies to soil or water conservation expenses which are attributable to assessments for depreciable property as provided by the new provision. As under existing law, such assessments (and amortization deductions for the taxable year arising out of the new provision) must be aggregated with a farmer's own soil and water conservation expenses for the taxable year for purposes of applying the 25-percent limitation set forth in section 175(b) of the code.

The provision applies to assessments levied after the date of the enactment of the bill. It is immaterial that the depreciable property may have been acquired by the district prior to that date.

The Treasury Department has indicated that it does not object to the enactment of this provision.

## III. DISCRIMINATION ON ACCOUNT OF SEX OR AGE IN RETIREMENT PLANS OR PRACTICES

*Reasons for provision.*—Under title VII of the Civil Rights Act of 1964 (the equal employment opportunity title) and the Age Discrimination in Employment Act of 1967, it is unlawful for certain employers to fail or refuse to hire, or to discharge, any individual, or to discriminate against any employee, with respect to a number of specified aspects of employment because of race, color, religion, sex, national origin, or age. In the case of the discrimination prohibited by the Age Discrimination in Employment Act of 1967, a specific exception is provided for the situations where the actions of the employer are necessary to comply with the terms of any bona fide employee benefit plan, such as a retirement or pension plan. No similar specific exception, however, is provided in the case of title VII of the Civil Rights Act. Nevertheless when Congress originally enacted title VII, the committee believes it is clear that Congress did not intend to prohibit reasonable differences in treatment of male and female employees under retirement or pension plans generally, since differential treatment is accorded men and women under the social security program today.

On February 24, 1968, however, the Equal Employment Opportunity Commission issued a regulation regarding pension and retirement plans (29 C.F.R. 1604.31). This regulation provides that it is unlawful for an employer to differentiate between male and female employees with regard to either optional or compulsory retirement ages under pension and retirement plans. The Commission's interpretation on this matter is not consistent with the committee's view of the intent of Congress in enacting title VIII of the Civil Rights Act of 1964.

It is not uncommon for a pension or retirement plan to differentiate between male and female employees with regard to optional or compulsory retirement ages or to require retirement at specified ages, frequently before attaining age 65. Moreover, the retirement practice of many employers provides for a differentiation in optional or compulsory retirement ages between male and female employees or provides for, or requires, retirement at certain ages. In fact, the congressional view on this matter would appear to be specifically indicated by the retirement differentiation for sex it has provided in the social security program.

Neither the intent of Congress in enacting title VII of the Civil Rights Act of 1964 and the Age Discrimination in Employment Act of 1967, nor the primary purpose of those acts—the hiring of workers on a nondiscriminatory basis—would be served by making it unlawful for an employer's pension or retirement plan or retirement practice to differentiate between male and female employees with regard to optional or compulsory retirement ages or to provide for optional or compulsory retirement at specified ages. Accordingly, the committee's amendment provides that these types of differentiation or retirement requirements are not to be considered unlawful.

*Explanation of provision.*—The committee's amendment provides that the terms or conditions of a pension or retirement plan (which is a qualified plan under sec. 401 of the Internal Revenue Code of 1954), or of a retirement practice, are not to be considered as violating title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1967, any Executive order, or any rules or regulations issued under any of these because such terms or conditions (*a*) provide for reasonable differentiation in optional or compulsory retirement ages between male and female employees or (*b*) provide for or require retirement at reasonable ages. This rule is to apply to new and existing pension plans or retirement plans, and to both the establishment and maintenance of these plans. It is important to note that the differentiation in retirement ages and the retirement age requirements which are allowed under the committee's amendment are only those which are reasonable. Moreover, the rule provided in the committee's amendment is not to excuse the failure or the refusal to hire individuals or the discharging of individuals prior to retirement age on account of either their sex or their age. In addition, the rule provided in the amendment is not to apply if the terms and conditions of the pension or retirement plan or the retirement practice are merely a subterfuge to evade the basic purposes of title VII of the Civil Rights Act of 1964 or the Age Discrimination in Employment Act of 1967.

## IV. RETROACTIVE QUALIFICATION OF CERTAIN UNION-NEGOTIATED PENSION PLANS

*Reasons for provision*.—Under present law, a pension trust is qualified for income tax exemption only if it meets certain requirements relating to coverage of employees and nondiscrimination of contributions or benefits. Where the pension trust is properly qualified, in addition to it being exempt from Federal taxation with respect to its income, contributions paid to it by an employer on behalf of his employees also are deductible for Federal income tax purposes.

In 1964 Congress added to the tax law a provision (sec. 401(i)) which provides that a trust which is a part of a pension plan which the Treasury Department has found to be a "qualified trust" exempt from taxation is, if certain conditions are met, to be considered a trust which was "qualified" and one which was exempt from taxation for the period beginning with the date when the contributions were first made to the trust rather than beginning with the date the trust otherwise first constituted a "qualified trust." For this retroactive qualification to be made available to a pension trust, it must establish to the satisfaction of the Treasury Department that three conditions have been met. First, the Treasury Department must be satisfied that the trust was created under a collective bargaining agreement with two or more employers who are not related. Second, it must be shown to the satisfaction of the Treasury Department that the disbursements made from the trust prior to actual qualification substantially meet the tests under which the pension plan subsequently qualifies. Third, the Treasury Department must be satisfied that prior to the time the trust constituted a qualified plan the contributions made to the trust were not used in a manner which jeopardized the interests of the beneficiaries.

A case has been called to the attention of the committee which would qualify under the provision described above but for the fact that it involves a single employer rather than multiple employers. This case involves the pension trust set up by the National Tea Co. for its employees. The committee has been informed that other cases also have arisen which would qualify but for the fact of a single employer. The principal difficulty experienced in the past was that of having a "definite written program and arrangement which is communicated to the employee" prior to the time the program is begun. Because of the difficulties in collective-bargaining agreements in presenting a complete schedule of benefits before contributions were made to the trust, it has proved difficult to qualify union-negotiated pension plans where more than one employer was involved. Moreover, the employers are required by the collective bargaining agreement entered into to begin making contributions when the agreement is signed. In the absence of a qualified plan, the required contributions, where they are not vested, cannot be deducted by the employers. The problem presented by the National Tea Co. and its union-negotiated plan indicates that similar difficulties arise with single employers as well.

In view of these considerations, the committee believes that it is desirable to extend the application of the provision in existing law to cover union-negotiated single-employer pension plans. As was true in the case of the multiemployer plans, safeguards are provided against

any abuse as to disbursements made by the trust prior to actual qualification and as to the use of the contributions while held by the trust.

*Explanation of provision.*—The committee has amended the provision of present law (sec. 401(i) of the code) by striking out the references to multiple employers and providing instead that the trusts must be created pursuant to a collective bargaining agreement between employee representatives and one or more employers.

This provision is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954, with respect to contributions made after December 31, 1954. This is the same effective date made applicable to the earlier provision.

The Treasury Department indicated it had no objection to this provision.

## V. ACCUMULATION OF INCOME BY CERTAIN TAX-EXEMPT ORGANIZATIONS AND CHARITABLE DEDUCTION TRUSTS

*Reason for provision.*—Under present law, the tax-exempt status of certain organizations and the unlimited charitable deduction available to trusts are denied if income is unreasonably accumulated by the organization or trust. These restrictions on accumulations do not apply to income attributable to property transferred by will to a trust where (1) the trust was created by the will, and (2) decedent died before January 1, 1951. The 1951 date was provided in these cases because this was the effective date of the restrictions on accumulations of income. Although not limited to mandatory accumulations, the general reason for these exceptions was the belief that it was unfair to tax accumulations where the accumulations were required by will under terms established before the provision restricting accumulations was adopted.

It has come to the committee's attention that a similar situation exists as to irrevocable inter vivos trusts, also created before the restrictions as to accumulations were adopted where the trust instruments require income to be accumulated. In this situation, these trusts were established (and could not be changed) at a time when the restrictions as to accumulations did not exist, and therefore could not have been taken into account by the creators of the trusts. It is for this reason—there is no rational reason for distinguishing between testamentary and inter vivos trusts where both are making mandatory accumulations—that the committee's amendment makes the restrictions on income accumulations inapplicable to inter vivos trusts in circumstances where they would be inapplicable to mandatory accumulations of income from property transferred by will. The amendment does not, however, extend the inapplicability of the unreasonable accumulation provisions to voluntary accumulations in the *inter vivos* case, as there appears to be no unfairness in subjecting voluntary accumulations to those provisions.

One specific case called to the attention of the committee was that of the Duke Endowment trust. In 1924 Mr. James B. Duke established an irrevocable trust creating the Duke Endowment and transferred property to it worth $40 million. The trust agreement provided that

20 percent of the net income from this amount must be accumulated until $40 million had been added to the corpus. On the same day Mr. Duke established this irrevocable trust, he also executed his will. He died in 1925 and under this will the corpus of The Duke Endowment trust was increased to $103.9 million, but no mandatory accumulation was required with respect to this additional corpus.

According to information furnished the committee, from 1924 through 1966, the mandatory accumulations of the Duke Endowment trust have amounted to slightly over $22 million or 7.6 percent of the $289 million of gross income earned during this period. They have been invested and added to assets and have produced additional estimated income of nearly $20 million which has not been accumulated but rather paid over to the beneficiaries. Within specific guidelines the trustees distribute the net income after the mandatory accumulations referred to above in the following manner:

32 percent to Duke University.
32 percent for hospitals.
5 percent to Davidson College.
5 percent to Furman University.
4 percent to Johnson C. Smith University.
10 percent to orphanages.
2 percent to superannuated Methodist ministers.
6 percent to building rural Methodist churches.
4 percent to maintaining and operating Methodist churches.

At the end of 1966, of the $289 million of income earned from the time of the inception of the trust, $222.9 million has been paid to beneficiaries for education, health, child care, and religion; and $24.2 million has been set aside but is currently available to beneficiaries for the same purposes; expenses have amounted to $17.5 million; unallocated income has amounted to $2 million; and the amount added to principal as required by the terms of the trust indenture has been $22.2 million.

*Explanation of provision.*—The committee's amendment provides that the restrictions on accumulations are not to apply to the income of inter vivos trusts if three conditions are met: First, the accumulated income is attributable to property transferred to the trust before January 1, 1951, by the creator of the trust. Second, the trust has been irrevocable since that date. Third, the income is required to be accumulated pursuant to the mandatory terms of the instrument creating the trust, as in effect on that date and at all times thereafter.

The amendment applies to taxable years beginning after December 31, 1950, the general effective date of the provision relating to unreasonable accumulations of income.

The Treasury Department has indicated that it has no objection to this provision but points out that this provision, insofar as it deals with the Duke Endowment trust, is concerned only with mandatory accumulations and does not affect the tax status of any voluntary accumulations.

## VI. ADVERTISING INCOME DERIVED BY TAX-EXEMPT ORGANIZATIONS FROM PUBLISHING PERIODICALS

*Reasons for provision.*—Under present law, certain tax-exempt organizations are taxable on income which they derive from the regular

conduct of an unrelated trade or business. In general this includes educational and charitable organizations, religious organizations other than churches, labor and agricultural organizations, business leagues, chambers of commerce, etc., and certain other exempt organizations. For this tax to apply, the trade or business must be one which is not substantially related (aside from the need for funds) to the exercise or performance by the organization of its exempt purpose.

The Treasury Department regulations which were in effect prior to December 12, 1967, did not specifically deal with the issue of what, if any, advertising income, which a tax-exempt organization derived from publishing a periodical, constituted unrelated business taxable income. While the Treasury Department has informed the committee that studies were going on during this period as to the status of this advertising income, nevertheless prior to this time tax was not asserted with respect to any advertising income where the editorial material in the periodical was related to the exempt purpose of the organization.

On December 11, 1967, the Treasury Department issued revised regulations regarding this subject in Treasury Decision 6939. In general, these new regulations for taxable years beginning after December 12, 1967, treat as unrelated business income the advertising income (to the extent in excess of advertising expenses) derived by a tax-exempt organization from publishing a periodical. However, this income is not taxed to the extent used to offset a loss from the operation of the periodical but is taxed to the extent of any additional income even though used for the exempt purpose. The new regulations also continue for years beginning before December 13, 1967, the regulations previously in effect which do not specify that advertising income from periodicals of exempt organizations is taxable.

Many persons have expressed the view that these new regulations go beyond the intent of Congress in taxing the type of advertising income referred to above. Moreover, the new regulations affect a large number of tax-exempt organizations. It is estimated that approximately 700 organizations are involved. Because of the considerations set forth above, the Senate, when it considered the recently enacted Revenue and Expenditure Control Act of 1968, adopted an amendment dealing with this subject. This amendment was deleted in conference with the understanding that the House Committee on Ways and Means would consider the matter later in the year. On July 1, 1968, the chairman of the House Committee on Ways and Means announced that the Ways and Means Committee, if its schedule permitted, intended to conduct public hearings on this subject in the near future. The large number of requests received by the committee from persons who wished to testify on this subject, however, has necessitated holding these hearings in abeyance until sufficient time is available.

In view of the substantial impact of the new regulations and the widespread concern which has been expressed regarding them, the committee believes it is appropriate to defer the application of the new regulations for a period of 1 year. This will provide an opportunity for Congress to examine the subject and to determine whether it believes legislation is desirable.

*Explanation of provision.*—The committee's amendment provides that, for purposes of applying the unrelated business income tax with respect to commercial advertising in a periodical published by a tax-

exempt organization which contains editorial matter related to the exempt purpose of the organization, the new regulations contained in Treasury Decision 6939 (sec. 1.512(a)-1 and 1.513-1) are to be applicable only with respect to taxable years beginning after December 12, 1968. This delays the effective date of these regulations (and therefore postpones taxing income from these advertising activities) for a period of 1 year. The regulations presently applicable to taxable years beginning before December 13, 1967 (secs. 1.512(a)-2 and 1.513-2) are to continue to apply in these situations for another year; that is, they are to be applicable in the case of taxable years which begin before December 13, 1968.

## VII. SPINOFF BY LIFE INSURANCE COMPANY

*Reasons for provision.*—The Life Insurance Company Income Tax Act of 1959, in general, provides that a life insurance company is taxable currently on its taxable investment income plus 50 percent of its remaining gain from operations. The remaining portion of its gain from operations is taxed to the company only when, and if, this amount is distributed to shareholders.

Under the Life Insurance Tax Act, the portions of the insurance company's income taxed currently are placed in a "shareholders surplus account," which is treated as the first amount distributed to shareholders. The portion of the life insurance company's gain from operations not taxed currently is placed in a "policyholders surplus account." Distributions from this account are considered as being made only when distributions to shareholders are in excess of the amount in the shareholders account, and distributions out of this policyholder account give rise to the so-called phase III tax on life insurance companies; that is, the deferred tax becomes due when the amounts are distributed to the shareholder. Included in the distributions which may give rise to this tax are distributions in redemption of stock, distributions in partial liquidation and a distribution in a "spinoff" (a distribution of a subsidiary's stock to the shareholders of the life insurance company) which is tax free to the shareholders receiving the stock.

In the past three exceptions have been made to the rule that there be phase III consequences in the case of a spinoff to shareholders of the stock of a subsidiary of a life insurance company:

1. In 1962 (Public Law 87-858) an amendment was adopted permitting a life insurance company to distribute the stock of a controlled fire and casualty insurance subsidiary without any phase III tax consequences if the subsidiary was acquired before January 1, 1963, in a tax-free, stock-for-stock reorganization.

2. In 1964 (Public Law 88-571) the exception was extended to cover the spinoff of a fire or casualty subsidiary, without regard to the type of corporate reorganization in which the parent had obtained control of the subsidiary, where the parent had owned 80 percent or more of the stock of the subsidiary before January 1, 1958 (the effective date of the Life Insurance Company Income Tax Act of 1959).

3. In 1967 (Public Law 90-225) an exception was made with respect to the spinoff of the stock of a subsidiary corporation where the subsidiary also is a life insurance company. The amendment permits

the spinoff without phase III tax consequences where a holding company owns at least 80 percent of the stock of a "first-tier" life insurance subsidiary which in turn owns at least 80 percent of the stock of a "second-tier" life insurance subsidiary. In such a case a distribution to the parent holding company of the stock of the second-tier subsidiary, where the distribution is otherwise tax free, is not to give rise to phase III tax consequences for the first-tier life insurance company if it has owned at least 80 percent of the stock of the second-tier life insurance company at all times since December 31, 1957. To the extent there were contributions to the capital of the second-tier company after December 31, 1957, these amounts are to be subject to phase III tax consequences on the spinoff of its stock.

Another case has recently been brought to the attention of the committee. The only difference in this more recent case is that the second-tier subsidiary is not a life insurance company but rather an ordinary corporation subject to the general corporate tax provisions. In this case the life insurance company wants to spin off the stock of the ordinary business subsidiary to simplify the operations of the group of corporations along functional lines. In addition, it wants to spin off the stock because certain States are considering legislation directed against the continued ownership by life insurance companies of noninsurance business interests. To deal with this situation, and for other business reasons, the companies desire to spin off the stock of the second-tier ordinary business subsidiary to the parent holding company.

The second-tier ordinary business subsidiary in the case brought to the committee's attention has been owned by the life insurance company since before the enactment of the Life Insurance Company Income Tax Act of 1959 and for that reason the distribution would not remove funds from the possible application of the phase III tax which were accumulated since the passage of that act. However, the removal of any assets, whenever or however acquired, from the possible application of the phase III tax does lessen the certainty of the ultimate payment of this tax by the life insurance company. This problem is particularly important where it is other than an insurance company which is being spun off since in such cases the assets cannot be expected to be held for use in an insurance company and could be sold, or distributed to shareholders, without the application of a phase III tax. To forestall this result, the committee has amended the provision initially presented to it. The committee amendment permits the spinoff of the second-tier ordinary business subsidiary to the parent holding company without the application of phase III tax consequences at that time. However, the amendment provides that the phase III tax is to continue to apply in such a case to the full extent, and in the same manner, as if the spinoff had not been made and the distributions to the parent company were therefore channeled to it through the life insurance company. As a result, any distributions made by the ordinary business subsidiary are to be treated as reducing the shareholders surplus account or the policyholders surplus account (as the case may be) of the life insurance company to the full extent of the distribution and thus are to give rise to a phase III tax in all cases in which a distribution by the life insurance company would give rise to a phase III tax. The sale (or other disposition) of the stock of the ordinary business subsidiary by the parent holding company also is

to be treated as reducing the shareholders surplus account or policyholders surplus account of the life insurance company. These effects are limited to the amount of the fair market value of the stock of the ordinary business corporation at the time of the spinoff.

*Explanation of provision.*—This amendment applies in cases where a life insurance company which owns all the stock of a business subsidiary distributes the stock to a parent company which immediately after the distribution owns all the stock of both the life insurance company and the business subsidiary. In such a case, a distribution to the present holding company of the stock of the business subsidiary by the life insurance company, where the distribution is tax-free (under sec. 355), is not to give rise to any phase III tax (or any reduction in either the shareholders or policyholders surplus accounts) for the life insurance company if it has owned all the stock of its subsidiary at all times since December 31, 1957.

The amendment further provides, however, that distributions by the spunoff subsidiary to the parent holding company are to result in reductions in the shareholders surplus account or policyholders surplus account (as the case may be) of the life insurance subsidiary in the same manner and to the same extent as if the distribution had been made by the life insurance company itself until the amounts so distributed by the spunoff subsidiary equal the fair market value of the stock spun off. The same treatment is also accorded any dispositions of stock of the spunoff subsidiary by the parent holding company.

This amendment applies to taxable years beginning after December 31, 1967.

The Treasury Department opposed the initial provision which would have removed the spunoff subsidiary's assets from the possible application of the tax. The committee believes its amendment should remove the objection of the Treasury Department.

## VIII. LOSS CARRYOVER OF INSURANCE COMPANY ON CHANGE OF FORM OF ORGANIZATION OR NATURE OF INSURANCE BUSINESS

*Reasons for provision.*—Under existing law the rules governing the income tax treatment of insurance companies differ somewhat depending on the form of the companies' organization (stock or mutual) and the nature of the companies' insurance business (life, casualty, etc.). An insurance company which incurs losses during periods when it is subject to tax under one set of rules in the past has not been able to carry these losses forward and deduct them (as it could if its status had not changed) during periods in which the company is subject to tax in a different status. This has been provided in the past primarily because, given the different ways of computing income or loss for different types of insurance companies, a loss of one type of organization carried over to a period when it is taxed as another type might result in too generous treatment. For instance, until 1962 mutual fire and casualty insurance companies were not taxed on their underwriting income and conversely were not permitted to deduct their underwriting losses. Since 1962, however, losses of all types of insurance companies are taken into account for tax purposes, and it is no longer appropriate to continue to prevent losses from being carried

over when an insurance company shifts from one set of tax rules to another. As a matter of fact, denying the deduction of a loss carryover in this manner inhibits an insurance company from engaging in transactions in which it would otherwise engage. The committee sees no reason for this if the company, in changing its form of organization or the nature of its insurance business, does not receive a more favorable operating loss carry-forward than it would receive in the case of either type of organization.

For the reasons given above, the committee's amendment—subject to limitations on the loss—permits an insurance company to carry over and deduct a net operating loss when the company, as a result of a change in its form or organization or the nature of its insurance business, becomes subject to a different type of insurance company taxation. In permitting these losses to be carried over, the amendment eliminates tax considerations from what should be essentially a business decision as to the type of business the organization is to seek.

*Explanation of provision.*—This amendment modifies the existing tax treatment of insurance companies to permit them to take deductions for loss carryovers even though their insurance company tax status changes (such as from a mutual casualty, etc., company to a stock casualty, etc., company or to a life insurance company or vice versa). Subject to one special rule the amendment permits the deduction subject to the normal conditions and limitations which govern loss carryovers, generally. This special rule limits the amount of the allowable loss carryover, where an insurance company's tax status has changed, to the lesser of the loss carryover as computed under the rules applicable to the company before the change or the loss carryover as computed under the rules which will apply to the company after the change. The provision authorizes the issuance of regulations to prescribe the rules necessary to effect this result.

The provision applies to the carry-forward losses incurred by insurance companies in periods beginning on or after January 1, 1963 (the date on which the insurance company tax provisions were substantially revised), but it does not permit a deduction to be taken under the new rules for any taxable year beginning before January 1, 1967. The fact that a company's tax status changed before 1967 is immaterial if the loss deduction carried over from the prior type of insurance company is not deducted before 1967. This is true, for example, if the change was a result of acquiring, or having been acquired by (in a merger or otherwise), another insurance company in a tax-free reorganization before the effective date of the amendment.

The Treasury Department does not object to the substance of this provision.

## IX. DEVELOPMENT COMPANIES TREATED AS REGULATED INVESTMENT COMPANIES

*Reasons for the provision.*—Present law treats electing regulated investment companies (mutual funds) as conduits, taxing these corporations only on the income which they retain and do not distribute to shareholders. The shareholders of the corporations, of course, are taxable on the dividends they receive.

Included in the qualifications for regulated investment company is a requirement that they diversify their investments within prescribed

limits. They must invest at least 50 percent of their assets in cash, cash items, and certain corporate securities. These securities, in respect of any one issuer, may not represent more than 5 percent in value of the companies' total assets or more than 10 percent of the outstanding voting stock of the issuer. These valuations are made on a quarter-by-quarter basis. Investments in securities which do not come within the prescribed 5- and 10-percent limits do not count toward fulfilling the overall 50-percent test.

An exception to the 5- and 10-percent limits applies in the case of so-called development companies. A development company is one which is principally engaged in furnishing capital to other corporations which themselves are "principally engaged in the development or exploitation of inventions, technological improvements, new products, or products not previously generally available to the public." For a company to qualify as a development company and thus be eligible for the exception, it must receive the certification of the Securities and Exchange Commission that it is investing in the prescribed type of corporations.

A company which receives SEC certification as a development company under limited circumstances may include investments in securities of one or more issuers in excess of the 5- and 10-percent limits toward fulfilling the overall 50-percent investment diversification test. The company may do so if the cost (or other tax basis) of the investment in the particular issuer, at the time of the latest acquisition of any securities of an issuer does not then exceed 5 percent of the value of the development company's total assets. This valuation is made only at the time of the initial investments. The exception to the regular 5- and 10-percent limits only applies for investments in the securities of any one issuer during a period of 10 years from the time of the first investment in the securities of that issuer.

The exception to the 5- and 10-percent limits described above applies for development companies only where a special 10-year rule is complied with. Thus the development company may not maintain its special status where it holds more than 25 percent of the value of its assets is represented by securities of one or more issuers in which it has held an interest for 10 years or more and in each of which the development company's holdings exceed the regular 10 percent limit on investments in these companies.

As a result of this special limitation, a development company which under SEC certification otherwise could continue to make investments in excess of the 5- and 10-percent limits cannot do so where more than 25 percent of the value of its assets is in the specified securities held for over 10 years. However, the company may continue to qualify as a regulated investment company by reason of a savings provision in present law. This provision, in effect, provides that a company which once qualifies as a regulated investment company is not to lose its status as such except through the acquisition of securities or other property. The anomaly of this result is that a company whose basis for being taxed as a regulated investment company was that it operated as a development company may continue to be taxed as such even though in effect the company may no longer meet the requirements of a development company.

The attention of the committee has been called to a situation under present law in which the provisions described above are operating in

a way which frustrates the intended investment activities of a publicly held certified development company. One out of a current portfolio of approximately 40 investments of the development company referred to has appreciated in value to the extent that this investment in the securities of one issuer represents in terms of value more than 25 percent of the company's assets and these securities have been held for more than 10 years. As a result the company no longer complies with the special 25-percent rule and therefore must (1) distribute the securities to its shareholders, (2) sell the "excess" securities (i.e., its holdings over the 25 percent held for over 10 years), or (3) retain the securities and retain its regulated investment company status under the general savings provision by not making new investments of the type it ordinarily makes.

Neither the first nor the third alternatives noted above are in accord with the statutory purpose of the development company tax provision. Distributing the securities to the development company's shareholders would not provide the company with funds for investment in corporations engaged in developing or exploiting new products. Similarly, the company's refraining from future investments also would not provide funds for investments in these corporations. However, the second alternative available to the development company, that of selling all its "excess" securities, simply is not practical from the company's or its shareholders' standpoint. The securities represent a significant interest in the issuer, and a forced sale of all the securities could be expected to provide substantially less than the current fair market value of the securities. What the company in the absence of legislation is doing, therefore, is selling the securities in relatively small blocks. This procedure will provide the company with funds for investments in other corporations marketing new products and accords with the statutory purpose of the development company tax provisions.

The committee concluded that the solution to the problem described above is to give the development company time to market its investment in an orderly fashion. The committee also concluded that in the future a development company which fails to meet the new limitations adopted by the committee should not be able to continue to qualify as a regulated investment company by applying the so-called savings provision referred to above.

*Explanation of provision.*—As explained above, existing law provides that a company may not qualify as a development company if more than 25 percent of the value of its assets is in securities of issuers with respect to each of which the company exceeds the prescribed 10-percent limit on investments and with respect to each of which the company has held securities for a continuous 10-year period. This amendment extends the 10-year period to 20 years. It does so, however, only if the company evidences its intention to comply with the 25-percent limit by the close of the 15th year and continues to do so at the end of subsequent years. The company must evidence this intention by reducing the value of its excess holdings in these issuers by at least 40 percent (i.e., 40 percent of the difference between the aggregate value of the holdings and 25 percent of the value of the development company's total assets). The reduction must be either on a pro rata basis with respect to each security of the various issuers or to the extent not pro rata it must be in those securities where the appreciation in value

since the time of acquisition has been above the average. Thus the company cannot comply with the amendment, and thereby continue to qualify as a development company, by disposing of those securities which would result in the smallest taxable gain.

Under the amendment, if at the close of the 15th year (and at the close of each year thereafter) a development company has not reduced its excess holdings by the prescribed 40-percent amount the company does not qualify as a development company for that year, unless at that time these securities which it has held 10 or more years then do not constitute more than 25 percent of the value of its total assets. Under the amendment the company may not use the general savings provision to qualify as a regulated investment company for that year. If the company does reduce its excess holdings by the prescribed amount (or if these holdings constitute 25 percent or less of the value of its total assets), the company may continue to qualify as a development company so long as it continues at the close of each year to meet one of these tests applicable to securities it has held for 10 or more years. Also under the committee amendment at the close of the 20th year in order to continue to qualify as a development company, the value of the securities which it has held for 20 or more years must not in any event exceed 25 percent of the value of its total assets. As in the case of the new limitation which becomes first applicable at the end of the 15th year, if the company fails to meet the limitation on its holdings of 20-year securities, the company does not qualify for that year as a development company and cannot use the general savings provision to qualify as a regulated investment company for that year.

This amendment applies with respect to taxable years beginning on or after January 1, 1967, except that the prohibition against reliance on the general savings clause in order to qualify as a regulated investment company applies to taxable years beginning after the date of enactment.

The Treasury Department has indicated it does not object to this provision.

## X. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

# INTERNAL REVENUE CODE OF 1954

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**SEC. 175. SOIL AND WATER CONSERVATION EXPENDITURES.**

(a) IN GENERAL.—A taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(b) LIMITATION.—The amount deductible under subsection (a) for any taxable year shall not exceed 25 percent of the gross income

derived from farming during the taxable year. If for any taxable year the total of the expenditures treated as expenses which are not chargeable to capital account exceeds 25 percent of the gross income derived from farming during the taxable year, such excess shall be deductible for succeeding taxable years in order of time; but the amount deductible under this section for any one such succeeding taxable year (including the expenditures actually paid or incurred during the taxable year) shall not exceed 25 percent of the gross income derived from farming during the taxable year.

(c) DEFINITIONS.—For purposes of subsection (a)—

(1) The term "expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming" means expenditures paid or incurred for the treatment or moving of earth, including (but not limited to) leveling, grading, and terracing, contour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of windbreaks. Such term does not include—

(A) the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) any amount paid or incurred which is allowable as a deduction without regard to this section.

Notwithstanding the preceding sentences, such term also includes any amount, not otherwise allowable as a deduction, paid or incurred to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district *(i)* which, if paid or incurred by the taxpayer, would without regard to this sentence constitute expenditures deductible under this [section.] *section, or (ii) for property of a character subject to the allowance for depreciation provided in section 167 and used in the soil or water conservation or drainage district's business as such (to the extent that the taxpayer's share of the assessment levied on the members of the district for such property does not exceed 10 percent of such assessment).*

(2) The term "land used in farming" means land used (before or simultaneously with the expenditures described in paragraph (1)) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

* * * * * * *

*(f) RULES APPLICABLE TO ASSESSMENTS FOR DEPRECIABLE PROPERTY.—*

*(1) AMOUNTS TREATED AS PAID OR INCURRED OVER 9-YEAR PERIOD.—In the case of an assessment levied to defray expenditures for property described in clause (ii) of the last sentence of subsection (c)(1), if the amount of such assessment paid or incurred by the taxpayer during the taxable year (determined without the application of this paragraph) is in excess of an amount equal to 10 percent of the aggregate amounts which have been and will be assessed as the*

*taxpayer's share of the expenditures by the district for such property, and if such excess is more than $500, the entire excess shall be treated as paid or incurred ratably over each of the 9 succeeding taxable years.*

*(2) DISPOSITION OF LAND DURING 9-YEAR PERIOD.—If paragraph (1) applies to an assessment and the land with respect to which such assessment was made is sold or otherwise disposed of by the taxpayer (other than by the reason of his death) during the 9 succeeding taxable years, any amount of the excess described in paragraph (1) which has not been treated as paid or incurred for a taxable year ending on or before the sale or other disposition shall be added to the adjusted basis of such land immediately prior to its sale or other disposition and shall not thereafter be treated as paid or incurred ratably under paragraph (1).*

*(3) DISPOSITION BY REASON OF DEATH.—If paragraph (1) applies to an assessment and the taxpayer dies during the 9 succeeding taxable years, any amount of the excess described in paragraph (1) which has not been treated as paid or incurred for a taxable year ending before his death shall be treated as paid or incurred in the taxable year in which he dies.*

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SEC. 401. QUALIFIED PENSION, PROFITMAKING, AND STOCK BONUS PLANS.

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(i) CERTAIN UNION-NEGOTIATED [MULTIEMPLOYER] PENSION PLANS.—In the case of a trust forming part of a pension plan which has been determined by the Secretary or his delegate to constitute a qualified trust under subsection (a) and to be exempt from taxation under section 501(a) for a period beginning after contributions were first made to or for such trust, if it is shown to the satisfaction of the Secretary or his delegate that—

(1) such trust was created pursuant to a collective-bargaining agreement between employee representatives and [two] *one* or more employers [who are not related (determined under regulations prescribed by the Secretary or his delegate)],

(2) any disbursements of contributions, made to or for such trust before the time as of which the Secretary or his delegate determined that the trust constituted a qualified trust, substantially complied with the terms of the trust, and the plan of which the trust is a part, as subsequently qualified, and

(3) before the time as of which the Secretary or his delegate determined that the trust constitutes a qualified trust, the contributions to or for such trust were not used in a manner which would jeopardize the interests of its beneficiaries.

then such trust shall be considered as having constituted a qualified trust under subsection (a) and as having been exempt from taxation under section 501(a) for the period beginning on the date on which contributions were first made to or for such trust and ending on the date such trust first constituted (without regard to this subsection) a qualified trust under subsection (a).

* * * * * * *

**SEC. 504. DENIAL OF EXEMPTION.**

(a) GENERAL RULE.—In the case of any organization described in section 501(c)(3) to which section 503 is applicable, exemption under

section 501 shall be denied for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemptions under section 501(a) of an organization described in section 501(c)(3); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3).

Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. *Paragraph (1) shall not apply to income attributable to property transferred to a trust before January 1, 1951, by the creator of such trust, if such trust was irrevocable on such date and if such income is required to be accumulated pursuant to the mandatory terms (as in effect on such date and at all times thereafter) of the instrument creating such trust.* In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

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SEC. 681. LIMITATION ON CHARITABLE DEDUCTION.

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(c) ACCUMULATED INCOME.—If the amounts permanently set aside, or to be used exclusively for the charitable and other purposes described in section 642(c) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out such purposes of the trust;

(2) are used to a substantial degree for purposes other than those prescribed in section 642(c); or

(3) are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,

the amount otherwise allowable under section 642(c) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)). Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. *Paragraph (1) shall not apply to income attributable to property transferred to a trust before January 1, 1951, by the creator of such trust, if such trust was irrevocable on such date and if such income is required to be accumulated pursuant to the mandatory terms (as in effect on such date and at all times thereafter) of the instrument creating such trust.* In the

case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

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**SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS.**

(a) GENERAL RULE.—For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, shall be treated as made—

(1) first out of the shareholders surplus account, to the extent thereof.

(2) then out of the policyholders surplus account, to the extent thereof, and

(3) finally out of other accounts.

* * * * * * *

(f) DISTRIBUTION DEFINED.—For purposes of this section, the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include—

(1) any distribution made by the corporation in its stock or in rights to acquire its stock;

(2) except for purposes of subsection (a)(3) and subsection (e)(2)(B), any distribution in redemption of stock issued before 1958 which at all times on and after the date of issuance and on and before the date of redemption is limited as to dividends and is callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of the issue price and the amount of any contribution to surplus made by the original purchaser at the time of his purchase;

(3) any distribution after December 31, 1963, of the stock of a controlled corporation to which section 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and if—

(A) control was acquired prior to January 1, 1958, or

(B) control has been acquired after December 31, 1957—

(i) in a transaction qualifying as a reorganization under section 368(a)(1)(B), if the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the controlled corporation, or

(ii) solely in exchange for stock of the distributing corporation which stock is immediately exchanged by the controlled corporation in a transaction qualifying as a reorganization under section 368(a)(1) (A) or (C), if the controlled corporation has at all times since its organization been wholly owned by the distributing corporation and the distributing corporation has at all times since December 31, 1957, owned stock representing not less than 50 percent of the total combined voting

power of all classes of stock entitled to vote, and not less than 50 percent of the value of all classes of stock, of the corporation the assets of which have been transferred to the controlled corporation in section 368(a)(1)(A) or (C) reorganization; [or]

(4) any distribution after December 31, 1966, of the stock of a controlled corporation to which section 355 applies, if such distribution is made to a corporation which immediately after the distribution is in control (within the meaning of section 368(c)) of both the distributing corporation and such controlled corporation and if such controlled corporation is a life insurance company of which the distributing corporation has been in control at all times since December 31, 1957[.] *; or*

*(5) any distribution after December 31, 1967, of the stock of a controlled corporation to which section 355 applies, if such distribution is made to a corporation which immediately after the distribution is the owner of all of the stock of all classes of both the distributing corporation and such controlled corporation and if, immediately before the distribution, the distributing corporation had been the owner of all of the stock of all classes of such controlled corporation at all times since December 31, 1957.*

[Neither paragraph (3) nor paragraph (4) shall] *Paragraphs (3), (4), and (5) shall not* apply to that portion of the distribution of stock of the controlled corporation equal to the increase in the aggregate adjusted basis of such stock after December 31, 1957, except to the extent such increase results from an acquisition of stock in the controlled corporation in a transaction described in paragraph (3)(B). If any part of the increase in the aggregate adjusted basis of stock of the controlled corporation after December 31, 1957, results from the transfer (other than as part of a transaction described in paragraph (3)(B) by the distributing corporation to the controlled corporation of property which has a fair market value in excess of its adjusted basis at the time of the transfer, paragraphs (3) [and (4)], *(4), and (5)*] also shall not apply to that portion of the distribution equal to such excess.

*(g) Certain Distributions Related to Former Subsidiaries.—If subsection (f)(5) applied to the distribution by a life insurance company of the stock of a corporation which was a controlled corporation—*

*(1) any distribution by such corporation to its shareholders (after the date of the distribution of its stock by the life insurance company), and*

*(2) any disposition of the stock of such corporation by the distributee corporation,*

*shall, for purposes of this section, be treated as a distribution to its shareholders by such life insurance company, until the amounts so treated equal the amount of the distribution of such stock which by reason of subsection (f)(5) was not included as a distribution for purposes of this section.*

* * * * * * *

***SEC. 844. SPECIAL LOSS CARRYOVER RULES.***

*(a) General Rule.—If an insurance company—*

*(1) is subject to the tax imposed by part I, II, or III of this subchapter for the taxable year, and*

*(2) was subject to the tax imposed by a different part of this subchapter for a prior taxable year beginning after December 31, 1962,*

*then any operations loss carryover under section 812, unused loss carryover under section 825, or net operating loss carryover under section 172, as the case may be, arising in such prior taxable year shall be included in its operations loss deduction under section 812(a), unused loss deduction under section 825(a), or net operating loss deduction under section 832(c)(10), as the case may be.*

*(b) LIMITATION.—The amount included under section 812(a), 825(a), or 832(c)(10), as the case may be, by reason of the application of subsection (a) shall not exceed the amount that would have constituted the loss carryover under such section if for all relevant taxable years such company had been subject to the tax imposed by the part referred to in subsection (a)(1) rather than the part referred to in subsection (a)(2). For purposes of applying the preceding sentence—*

*(1) in the case of a mutual insurance company which becomes a stock insurance company, the deduction under section 832(c)(11) (relating to dividends to policyholders) shall not be allowed, and*

*(2) section 812(b)(1)(A)(ii) (relating to additional years to which losses may be carried by new life insurance companies) shall not apply.*

*(c) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.*

* * * * * * *

**SEC. 851. DEFINITION OF REGULATED INVESTMENT COMPANY.**

(a) GENERAL RULE.—For purposes of this subtitle, the term "regulated investment company" means any domestic corporation (other than a personal holding company as defined in section 542)—

(1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940, as amended (54 Stat. 789; 15 U.S.C. 80a-1 to 80b-2), either as a management company or as a unit investment trust, or

(2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a).

(b) LIMITATIONS.—A corporation shall not be considered a regulated investment company for any taxable year unless—

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941;

(2) at least 90 percent of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities;

(3) less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months; and

(4) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by—

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses.

(c) RULES APPLICABLE TO SUBSECTION (b)(4).—For purposes of subsection (b)(4) and this subsection—

(1) In ascertaining the value of the taxpayer's investment in the securities of an issuer, for the purposes of subparagraph (B), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary or his delegate.

(2) The term "controls" means the ownership in a corporation of 20 percent or more of the total combined voting power of all classes of stock entitled to vote.

(3) The term "controlled group" means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) the taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

(4) The term "value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors, except that in the case of securities of majority-owned subsidiaries which are investment companies such fair value shall not exceed market value or asset value, whichever is higher.

(5) All other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended.

(d) DETERMINATION OF STATUS.—A corporation which meets the requirements of subsections (b)(4) and (c) at the close of any quarter shall not lose its status as a regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. A corporation which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after

the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter shall not lose its status for such quarter as a regulated investment company if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it shall be considered to have met such requirements at the close of such quarter for purposes of applying the preceding sentence. *If a corporation meets the requirements of subsection (b)(4)(A) at the close of any quarter of any taxable year (whether beginning before, on, or after the date of the enactment of this sentence) by reason of the application of the provisions of subsection (e), this subsection shall not apply to such corporation for any subsequent quarter of any taxable year (beginning after the date of the enactment of this sentence) for which the Securities and Exchange Commission fails to make the determination provided for in paragraph (1) of subsection (e) or for which the corporation fails to satisfy the limitation set forth in paragraph (2)(A) of subsection (e) or the limitation set forth in paragraph (2)(B) of such subsection.*

(e) INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.—

(1) GENERAL RULE.—If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate not earlier than 60 days prior to the close of the taxable year of a registered management company, that such investment company is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b)(4) for any quarter of such taxable year, include the value of any securities of an issuer, whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer, the basis of which, when added to the basis of the investment company for securities of such issuer previously acquired, did not exceed 5 percent of the value of the total assets of the investment company at the time of the subsequent acquisition of securities. The preceding sentence shall not apply to the securities of an issuer if the investment company has continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

[(2) LIMITATION.—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter

unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.]

(2) *LIMITATIONS.—*

(A) *EXCESS INVESTMENTS AFTER 15 YEARS.—If—*

"(i) *at the close of any taxable year (whether beginning before, on, or after the date of the enactment of this subparagraph), more than 25 percent of the value of the total assets of an investment company is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years, and*

(ii) *at the close of the fifth taxable year following such taxable year (but only if such fifth taxable year begins after the date of the enactment of this subparagraph), the investment company has not reduced by at least 40 percent its holdings of each issue of securities described in clause (i) which represented the excess investment in such securities (as determined under paragraph (5)),*

*the provisions of this subsection shall not apply at the close of any quarter of such fifth taxable year to such investment company, unless at the close of such year the securities described in clause (i) represent 25 percent or less of the value of its total assets (or are reduced to 25 percent or less of such value within 30 days thereafter).*

(B) *EXCESS INVESTMENTS AFTER 20 YEARS.—The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 20 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.*

(3) DETERMINATION OF STATUS.—For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Ex-

change Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

(4) DEFINITIONS.—The terms used in this subsection shall have the same meaning as in subsections (b)(4) and (c) of this section.

*(5) RULES FOR APPLICATION OF PARAGRAPH (2)(A).—*

*(A) EXCESS INVESTMENT.—For purposes of paragraph (2)(A), the excess investment with respect to any issue of securities described in clause (i) of such paragraph held by an investment company is an amount equal to an amount determined by multiplying—*

*(i) the aggregate value of the securities described in clause (i) of such paragraph, reduced by an amount equal to 25 percent of the value of the total assets of the investment company, by*

*(ii) a fraction the numerator of which is the value of such issue of securities and the denominator of which is the aggregate value of all securities described in such clause (i) held by the investment company.*

*(B) SUBSTITUTION FOR LESS-APPRECIATED SECURITIES.—If the percentage appreciation in value per share of any issue of securities described in clause (i) of paragraph (2)(A) is less than the average percentage appreciation in value per share of all issues of securities described in such clause, the reduction, or any part thereof, in the holdings of such issue required under clause (ii) of paragraph (2)(A) shall be treated as satisfied by a reduction (in addition to the reduction required under such clause) of a dollar amount of the holdings of any other issue of securities described in clause (i) of such paragraph, the average appreciation in value per share of which is higher than the average appreciation in value per share of all issues of securities described in such clause, equal to the dollar amount of such issue which would have to be disposed of to effectuate such reduction or such part. This subparagraph shall apply only if the investment company files a statement, at the time of making its return for the taxable year, identifying the transaction or transactions in which its holdings of such other issue were reduced in substitution for a reduction in the holdings of such issue.*

*(C) TIME FOR MAKING DETERMINATIONS.—For purposes of subparagraph (A) of this paragraph and clause (ii) of paragraph (2)(A), all determinations shall be made as of the close of the applicable taxable year referred to in clause (i) of paragraph (2)(A). For purposes of applying subparagraph (B) of this paragraph, all determinations shall be made at the time of the transaction identified by the investment company under such subparagraph.*

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