[COMMITTEE PRINT]

DESCRIPTION OF PROVISIONS LISTED FOR FURTHER HEARINGS BY THE COMMITTEE ON FINANCE ON JULY 20, 21, AND 22, 1976

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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TABLE OF CONTENTS

I. INTRODUCTION

The provisions described in this pamphlet are those on which the Committee on Finance will hold three consecutive mornings of public hearings beginning on Tuesday, July 20, 1976.

In announcing these hearings Senator Long noted that concern has been expressed as to whether certain provisions approved by the committee for incorporation in H.R. 10612, the Tax Reform Act, were the subject of sufficient hearings and discussion. Although the committee held four weeks of public hearings on the tax bill, but that the Committee, in the interest of expediting the bill for floor consideration, may not have examined some of the provisions as extensively as otherwise might have been the case. As a result, these hearings are intended to provide a more complete record on these provisions.

The amendments listed for consideration in these hearings include in some cases provisions on which testimony has already been taken by the Finance Committee in public sessions. The list also includes provisions contained in the House-passed bill on which Finance Committee modification was quite minor, provisions which have previously been approved by the House Ways and Means Committee, and other provisions which have passed the House in separate legislation.

In addition, the hearings include amendments called to the attention of the Committee by members during the extended markup session after the hearings. Senator Long pointed out that toward the end of the lengthy markup, the Finance Committee was under heavy pressure to report the tax bill to the Senate at the earliest possible time. He stated at the time that certain amendments not included in this bill, but recommended by the Committee, had been approved without the benefit of extensive hearings and study. He requested additional information, both for and against these amendments at the time, with the hope that the Committee would benefit from the information subsequently received. These hearings will provide an appropriate forum for the submission of such information.

Finally, the list includes a floor amendment imposing an at-risk limitation for limited partners, a provision not previously considered at Committee sessions.

This pamphlet was prepared by the staff to provide background information with respect to the provisions listed for consideration during the public hearings. The pamphlet describes each provision, indicating in each case the present law treatment, the issue involved, an explanation of what the provision will do (including the effective date of the provision), and the revenue effect of the provision (if any).

It has also been requested that the sponsors of the provisions be listed together with any persons that also would be indicated as those who will benefit from the provisions. To the extent this information is available to the staff, it is indicated in this pamphlet in the general explanation of each provision. However, since the markup session was

not a recorded session, no official record was kept of those who proposed the amendments. As a result, the staff has listed those it believes proposed the amendments where this information is available. As to those who benefit from the provisions, in many cases it is impossible to have any full listing of all taxpayers who do or may benefit from a particular provision. However, the staff has listed those it believes are interested in particular provisions where this has been called to the staff's attention. Other beneficiaries of provisions may have come to the attention of the Senators' offices.

III. DESCRIPTION OF BILLS

1. At-Risk Limitation for Limited Partners (sec. 210 of the bill—floor amendment—Congressional Record, June 22, 1976, pp. S10106–S10110)

Present law

Limited partnerships, which, upon meeting certain requirements, are subject to both the general partnership provisions and certain provisions of the income tax regulations having particular application to limited partnerships.

In general, a partnership is not considered a separate entity for tax purposes; rather, the individual partners are taxed currently on their share of the partnership gains and can deduct partnership losses to the extent of the basis of their partnership interest.

A limited partner is a passive investor who is not personally liable for any more than his equity contribution to the partnership (plus his agreed future contributions).

Commonly, the equity contributions of limited partners do not adequately capitalize the operations of a limited partnership. The additional capital frequently is obtained by borrowing, using partnership property as security, without the limited partnership or its partners incurring any personal liability with respect to that borrowing.

A limited partner may deduct from his personal income all the deductible items of the partnership which are allocated to him under the partnership agreement, but not more than the amount of his basis for his interest in the partnership, which is reduced by the amount of the deductions as they are taken.

In general, at the inception of the partnership, a limited partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. Under the Treasury's income tax regulations (§ 1.752–1(e)), the general rule is that "a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement." Thus, for example, if a limited partner who is obligated[1] under the partnership agreement to contribute $10,000 to the partnership makes an initial contribution of $1,000, his share of partnership liabilities would be limited under this rule to $9,000 ($10,000–$1,000).

This regulation further provides, however, that "where none of the partners have any personal liability with respect to partnership lia-

[1] This assumes that the obligation of the limited partner to make the contribution is unconditional. It is not clear whether this provision applies to conditional or contingent obligations of the limited partner to make a contribution.

bility (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits." [2] Through the use of this rule, a limited partner may obtain a substantial increase in his basis, and, thus, in the amount of losses he may deduct.[3]

In 1972, the Internal Revenue Service issued two rulings involving nonrecourse loans. While both rulings dealt with and have particular application to limited partnerships engaged in oil and gas exploration, they are susceptible to a much broader application. In Rev. Rul. 72–135, 1972–1 C.B. 200, the Service ruled that a nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would constitute a contribution to the capital of the partnership by the general partner, and not a loan, thereby precluding an increase in the basis of the limited partner's partnership interest with respect to any portion of such a loan. In Rev. Rul. 72–350, 1972–2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by highly speculative and relatively low value property of the partnership, and which was convertible into a 25 percent interest in the partnership's profits, did not constitute a bona fide debt, but was, in reality, equity capital placed at the risk of the partnership's business. This, too, would preclude increases in the bases of the limited partner's interests.

Issue

The issue is whether a limited partner should be allowed to increase the amount of the basis in his partnership interest by a portion of partnership indebtedness so as to allow him to deduct an amount of partnership losses which exceeds the amount of investment he actually has and will have at risk in the partnership.

Explanation of provision

This provision was a Senate floor amendment sponsored by Senators Haskell, Kennedy, Hollings, and Hathaway. It eliminates the special rule of the regulations (§ 1.752–1(e)) for allocation of nonrecourse liabilities to limited partners. Instead, it applies the general rule of regulations to both recourse and nonrecourse obligations.

This provision therefore restricts the amount of partnership liabilities which may be included in a limited partner's basis in his partnership interest to an amount equal to any further contributions (over and above any actual contributions) which the limited partner is obligated to make pursuant to the partnership agreement. The effect of this provision is to limit deductions which may be passed through to a limited partner to the amount of investment which he actually has and will have at risk in the partnership.

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[2] This rule has been justified as an adaptation to the limited partnership situation of a principle set forth by the United States Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

[3] For example, if a limited partner initially pays $1,000 and is unconditionally obligated to make further contributions totalling $9,000 for a 5 percent interest in the capital and profits and losses of a limited partnership which obtains a nonrecourse loan of $500,000, the limited partner's basis in his interest would be $26,000 ($1,000 plus 5% of $500,000). Thus, as a result of this rule, the limited partner may be able to deduct an amount far exceeding the amount of investment that he actually has and will have at risk in the partnership.

The provision applies to limited partnerships formed after June 30, 1976, except in the case of limited partnerships involved in the construction or rehabilitation of low income housing (within the meaning of section 1039(b)), where it will apply to limited partnerships formed after December 31, 1981.

This provision would have wide application to many diverse types of limited partnerships. Probably its most important impact would be in the case of limited partnerships concerned with real estate.

Revenue effect

It is estimated that this provision will result in an increase of $5 million in budget receipts in fiscal year 1977, $6 million in fiscal year 1978 and $90 million in fiscal year 1981.

2. Refunds of Unutilized Investment Tax Credits (sec. 802 of the bill)

Present law

Under present law, the investment tax credit generally cannot in any taxable year exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of the $25,000. Investment tax credits which cannot be used because of this limitation may be carried back 3 taxable years and used in those years to the extent possible within the limitation and then carried forward 7 taxable years and used in those years within the limitation. (In the case of public utilities, the 50-percent limitation increases to 100 percent in 1975 and 1976, 90 percent in 1977, 80 percent in 1978, 70 percent in 1979, 60 percent in 1980, and 50 percent thereafter.) Any remaining investment credit under present law cannot be used.

Issue

The issue is whether investment tax credits that will expire in the future because of insufficient tax liability to offset them should be refunded or whether the carryforward period should be extended.

Explanation of provision

This provision was proposed by Senator Long. It allows investment tax credits which are earned with respect to property which becomes eligible for the investment tax credit on or after January 1, 1976, and which cannot be entirely used during the 3-year carryback and 7-year carryforward period to be refunded at the expiration of the carryforward period. Thus, taxpayers who are unable to use investment tax credit resulting from investments in 1976, and over the next seven years (as well as the previous 3 years) will be entitled to a refund of such credits beginning in 1984.

This provision generally would be beneficial to low-profit or loss companies. Some have suggested that this provision would be particularly beneficial to airlines, railroads and utilities. However, this would appear to be true only in the case of those with low profits or losses currently and then only if they remain in that status until 1984.

Revenue effect

It is estimated that this provision will not affect revenues until 1984. In that year, it estimated that this provision will result in a reduction of revenues of $300 to $500 million.

3. Expiring Investment and Foreign Tax Credits (sec. 803 of the bill)

Present law

Under present law the investment tax credit for any year generally cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. If the amount of investment tax credit for any year exceeds the applicable limitation based on the amount of tax liability for that year, the excess is generally an investment credit carryback to each of the three preceding taxable years and an investment credit carryover to each of the seven following taxable years and, subject to certain limitations, is added to the amount allowable as a credit for those years (sec. 46(b)).[1] If any portion of a credit remains after application to the carryback and carryover periods, the unused portion expires and cannot be used subsequently by the taxpayer.

Present law provides, subject to certain limitations, for a two-year carryback and five-year carryforward of unutilized foreign tax credits (sec. 904). As in the case of the investment tax credit, any portion of a credit which remains unused after the application of the two-year carryback and five-year carryforward expires and cannot be used subsequently by the taxpayer.

Issue

During 1970–1971 and 1974–1975 the economy suffered two serious recessions. Nonetheless, in order to remain competitive domestically and internationally, many firms have continued to invest in new plant and equipment in the U.S. and have maintained their overseas business operations. However, where domestic operations have subsequently worsened and created net operating losses, these losses have often eliminated domestic income in earlier years and resulted in carryforwards of previously absorbed tax credits.

The issue is whether, in order to mitigate these problems, an additional carryforward period should be provided for the investment and foreign tax credits which would otherwise expire in 1976 (e.g. investment credits earned before 1970 and foreign tax credits earned in 1971).

Explanation of provision

This provision was proposed by Senator Long and subsequently modified by Senator Hartke. It establishes that investment and foreign tax credits that may be carried over to 1976, but which would otherwise expire after that year may be carried over for two additional years, to 1977 and 1978. This additional carryforward does not apply to credits that might expire in 1977 or 1978, but only to credits which would expire in 1976. Similarly, the additional carryforward in the case of the foreign tax credit does not apply to credits expiring in 1977 or 1978.

In addition, any foreign tax credit carryovers which otherwise would expire in 1976 but which have been extended through 1978 are to be used first in 1977 and 1978 against any foreign income received in those years (i.e., before any credits arising currently in those years).

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[1] However, certain pre-1971 investment credits are allowed a 10-year carryover.

This provision will tend to benefit low profit or loss companies, such as some airlines, utilities and railroads. It has been suggested that this provision will benefit Chrysler Corporation. While representatives of that company have indicated an interest in this provision, it is not clear that in its present form this provision will benefit this company.

Revenue effects

It is estimated that the additional two year carryforward of investment tax credit will result in a decrease in budget receipts of $14 million in fiscal year 1977 and $30 million in fiscal year 1978. It is estimated that the re-ordering of foreign tax credit carryforwards will result in a decrease in budget receipts by $2 million in fiscal year 1977, $3 million in fiscal year 1978, and $1 million in fiscal year 1981.

4. Investment Credit in the Case of Vessels Constructed from Capital Construction Funds (sec. 806 of the bill)

Present law

Present law provides that income tax is not to be payable on certain income from domestic shipping deposited in a capital construction fund. However, when monies are withdrawn from this fund, they then are generally taxable unless they are used for the construction of ships to be used primarily in domestic trade.

To prevent a double allowance for these tax-deferred amounts, present law provides that when these funds are used to finance ship construction there is to be no tax cost, or basis, in the ship. This means that no depreciation is permitted on the part of the investment in the ship that is financed out of the capital construction fund.

Under present law, the amount of the investment credit available is also based on ten percent of the tax cost or basis of a qualifying property (sec. 46(c)(1)(A) of the code). As a result, the Internal Revenue Service has ruled that no investment credit is available to the extent a vessel is built, purchased, or reconstructed with monies withdrawn from the capital construction fund.

Issue

The issue is whether or not to provide the investment tax credit for the full cost of constructing a qualified vessel under the Merchant Marine Act of 1970, rather than for the tax basis of such vessel.

Explanation of provision

This provision was proposed by Senator Long. A similar provision has previously been reported favorably by the Senate Commerce Committee and passed by the Senate. The provision requires that the amount of a qualified investment for investment tax credit purposes is not to be reduced because of a deposit in, or qualified withdrawal from, a capital construction fund established under section 21 of the Merchant Marine Act of 1970 or because that provision requires a reduction in basis of property acquired with monies from such a fund.

This provision should be of benefit to many members of the domestic maritime industry.

Revenue effects

It is estimated that the amendment will result in a reduction of $21 million in revenues in FY 1977, $23 million in FY 1978, and $45 million in FY 1981.

5. Foreign Trusts Having One or More U.S. Beneficiaries To Be Taxed Currently to Grantor (sec. 1011 of the bill)

Present law and committee amendment

Under present law, the income of a trust is taxed basically in the same manner as the income of an individual, with limited exceptions (sec. 642). Just as nonresident alien individuals are generally taxed only on their U.S. source income other than capital gains and on their income effectively connected with a U.S. trade or business (and not on their foreign source income), so any trust which can qualify as being comparable to a nonresident alien individual is generally not taxed on its foreign source income. If a trust is taxed in a manner similar to nonresident alien individuals, it is considered (under sec. 7701(a)(31)) to be a foreign trust.

The committee amendment contains a new grantor trust provision under which, in general, any U.S. person transferring property to a foreign trust which has a U.S. beneficiary is treated as owner of the portion of the trust attributable to the property transferred by the U.S. person. Any U.S. person treated under this provision as owner of a portion of a trust is taxed on the income of that portion of the trust in the same manner as an owner of a trust is taxed under the existing grantor trust rules (part I of subchapter J of the Internal Revenue Code).

Issue

The House provision applied to transfers of property to foreign trusts after May 21, 1974 (the date of the initial Ways and Means Committee decision). However, no news report of the committee decision was made until May 29, 1974. Thus, taxpayers who did not have access to individuals physically present at the Ways and Means Committee markup could not know of the committee decision. The issue is whether the date for applying the new grantor trust rules should be made May 29, 1974.

Explanation of provision

This provision was suggested by the staff as an alternative to the date in the House bill. The provision delays the date for which the new grantor trust rules apply from transfers of property to foreign trusts made after May 21, 1974, to transfers made after May 29, 1974. It has been reported that this provision will benefit trusts established by James L. Walker, Stanley L. Timmins, William B. Rapien, and Russell A. Kendall.

6. Investment in U.S. Property by Controlled Foreign Corporations (sec. 1021 of the bill)

Present law and committee amendment

Present law treats an investment in U.S. property by a controlled foreign corporation as a taxable distribution to the U.S. shareholders of the corporation. Present law is very broad as to the types of property which are classified as U.S. property for purposes of this rule.

The committee amendment narrows the types of investments that are treated as U.S. property and thus result in dividend taxation to the U.S. shareholders if an investment is made in the property by the controlled foreign corporation. Under the committee amendment, the term "U.S. property" does not include stock or debt of a domestic

corporation if the U.S. shareholders of the controlled foreign corporation are considered as owning less than 25 percent of the voting power of the domestic corporation. Also, movable drillings rigs are not considered as U.S. property when used on the continental shelf. The effective date of the committee amendment is generally for taxable years beginning after December 31, 1975.

a. Investments on the continental shelf

Issue

The issue is whether investments in assets located on the continental shelf or in stock or obligations of a U.S. corporation substantially all of the assets of which consist of property located on the continental shelf should be treated as U.S. property for the period prior to January 1, 1977.

Explanation of provision

This provision was in the House bill but was modified by the Senate Finance Committee so that it has no prospective application. The provision permits taxpayers to elect to exclude certain investments from the definition of United States property. The election applies retroactively to all taxable years beginning before 1977 to which the provision defining the United States to include its continental shelf (sec. 638) applies. This election only applies to property situated on, or used exclusively in connection with, the continental shelf or investments in stock or obligations of a domestic corporation, substantially all of the assets of which consist of such property. This provision will be of benefit to the Superior Oil Company.

b. Investments made after May 21, 1974

Issue

The issue is whether controlled foreign corporations which have made investments in property which is excluded from the definition of U.S. property under the committee amendment should be permitted to elect to apply the new definition of U.S. property to investments made after May 21, 1974 (the date of the initial Ways and Means Committee decision).

Explanation of provision

This provision was proposed by Senator Long. Taxpayers may elect to have investments in stock or obligations of a domestic corporation excluded from the definition of U.S. property if there is less than a 25-percent voting interest in the corporation and the investment was made after May 21, 1974. This provision will be of benefit to Pyramid Ventures Inc.

7. Exclusion from Subpart F of Certain Earnings of Insurance Companies (sec. 1023 of the bill)

Present law

One of the categories of foreign tax haven income subject to current taxation under present law is foreign personal holding company income (sec. 954(c)). This item of foreign tax haven income consists of passive investment income such as dividends, interest, rents and royalties. Present law provides an exception for income of

a foreign insurance company from its investment of unearned premiums or reserves which are ordinary and necessary for the proper conduct of its business.

Issue

In order to write insurance and accept reinsurance premiums, foreign insurance companies may be required by the laws of various jurisdictions in which they operate to meet various solvency requirements in addition to specified capital and legal reserve requirements. Many jurisdictions also employ an internal rule-of-thumb as to what the ratio of surplus to earned premiums should be. In the United States, the National Association of Insurance Commissioners employs a ratio of 1 to 3 (surplus to earned premiums) as the guideline by which State regulatory agencies can measure the adequate solvency of companies insuring casualty risks. Where the foreign jurisdiction does not impose requirements as severe as those required in the United States, a foreign insurance company participating in a reinsurance pool composed principally of companies doing business in the United States must, for all practical purposes, maintain this ratio to satisfy the State insurance authorities involved.

These various requirements mean that an insurance company must keep a reserve of assets in relatively short-term passive investments. As a result the question arises as to whether the income from these investments should be treated as tax haven income.

Explanation of provision

This provision was in the House bill and was not changed by the Senate Finance Committee. The provision adds a new exception to the definition of foreign personal holding company income (sec. 954(c)(3)(C)). Under the exception, foreign personal holding company income does not include dividends, interest, and gains from the sale or exchange of stock or securities derived from investments made by an insurance company of an amount of assets equal to one-third of its premiums earned (as defined under sec. 832(b)(4)) during the taxable year on insurance contracts (other than for life insurance and annuity benefits under life insurance and annuity contracts, to which sec. 801 pertains).

The exception only applies to passive income received from a person other than a related person (as defined in sec. 954(d)(3)). Also, the exception only applies with respect to premiums which are not directly or indirectly attributable to the insurance or reinsurance of related persons.

The provision applies to taxable years of foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporations end.

This provision applies to the American International Group, Inc.

Revenue effect

It is estimated that this provision will result in a decrease in budget receipts of $11 million in fiscal year 1977 and of $10 million per year thereafter.

8. Shipping Profits of Foreign Corporations (sec. 1024 of the bill)

Present law

One of the categories of foreign base company tax haven income subject to current taxation under the subpart F provisions of the Code is income derived from, or in connection with, the use of an aircraft or vessel in foreign commerce, except to the extent that the profits are reinvested in shipping assets.

a. Country of incorporation and registration

Issue

In general, foreign tax haven income includes income earned by a corporation outside the country of incorporation. In the case of shipping income, however, no distinction is made under present law between cases where a corporation derives its shipping income in the same country where it is registered and incorporated and flag of convenience corporations which operate all over the world (other than the country of incorporation.) The issue is whether shipping activities should be categorized as a base company activity when the corporation involved carries on its activities entirely in the country in which it is organized.

Explanation of provision

This provision was added in the House bill and was not changed by the Senate Finance Committee. It establishes an exception to the foreign tax haven rules for shipping income derived from the operation of a vessel or airplane between two points in the country in which the vessel or airplane is registered and the corporation owning the vessel or airplane is incorporated.

This provision affects the Hall Corporation Shipping Ltd.

b. Drilling rig service companies

Issue

The issue is whether an exception to the tax haven provisions should be added in the case of a supply shipping operation between a point on shore and nearby offshore points.

Explanation of provision

This provision was proposed by Senator Bentsen. It provides an exception from the foreign tax haven rules for shipping income derived from the transportation of men and supplies from a point in a foreign country to a point (such as an oil drilling rig) located on the continental shelf of that country or on the continental shelf adjacent to the continental shelf of that country.

This provision will affect all companies in the business of servicing oil drilling rigs. Interest has been expressed in this provision by the Jackson Maritime Company and the Tidewater Marine Service, Inc.

c. Short-term charter income

Issue

The issue is whether an exception to the tax haven provisions should be applied in the case of a foreign corporation if neither the corporation nor any related person is involved in the shipping business except by deriving short-term charter income.

Explanation of provision

This provision was proposed by Senator Long. It provides an exception from the foreign tax haven rules for shipping income derived by a corporation from the short-term charter of vessels if that corporation or any related person does not own any ships or shipping facilities and does not manufacture, grow or extract goods shipped on vessels used by that corporation.

The Southern Scrap Materials Company, Ltd. expressed interest in this provision but since it owns ship facilities, this provision will have no application to that company.

d. Investments in qualified shipping assets

Issue

When shipping assets are acquired by using funds obtained by unsecured loans, present law is unclear as to what shipping profits are considered as reinvested in shipping assets and thus entitle a controlled foreign corporation to an exclusion from the subpart F provisions.

Explanation of provision

This provision was in the House bill and not changed by the Senate Finance Committee. It clarifies the method of determining the amount of a controlled foreign corporation's qualified investments in shipping assets (sec. 955(b)(4)). Under the provision that a liability evidenced by an open account or a liability secured only by the general credit of the corporation is to be taken into account in determining the amount of the corporation's qualified investments in shipping assets, to the extent that such a liability constitutes a claim against the corporation's shipping assets. As a result, payments made by the corporation in discharge of an unsecured liability are treated under the amendment as increasing qualified investments in shipping assets, to the extent that the unsecured liability constitutes a claim against the corporation's shipping assets.

This provision has application to Hall Corporation Shipping Ltd.

9. Limitation on Definition of Tax Haven Income for Agricultural Products (sec. 1025 of the bill)

Present law

One of the categories of foreign tax haven income subject to current taxation under the subpart F provisions of the Code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

Issue

Questions have been raised as to whether this exclusion applies to all agricultural products which are of a different grade or variety from the same product grown in the United States. The Treasury has taken the position that the exception in present law is very narrow. In addition it is questioned whether all foreign grown agricultural goods should be excluded from the definition of tax haven income.

Explanation of provision

The basic provision was in the House bill. The modification made was suggested by the Treasury Department staff. The provision ex-

cludes, for purposes of the tax haven foreign base company sales rules of subpart F, agricultural commodities grown or produced outside the United States if sold for use, consumption, or disposition outside the United States.

This provision applies to taxable years of foreign corporations beginnings after December 31, 1975, and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporation.

This provision will affect most of the international grain corporations. Cargill, Inc., has been mentioned specifically as one beneficiary.

Revenue effect

It is estimated that this provision will reduce budget receipts by $17 million in fiscal year 1977, $15 million in fiscal year 1978, and $15 million in fiscal year 1981.

10. Repeal of the Per-Country Foreign Tax Credit Limitation (sec. 1031 of the bill)

Present law and committee amendment

In order to prevent a taxpayer from using foreign tax credits to reduce U.S. tax liability on income from sources within the United States, two alternative limitations on the amount of foreign tax credits which can be claimed are provided by present law. Under the overall limitation, the amount of foreign tax credits which a taxpayer can apply against his U.S. tax liability on his worldwide income is limited to his U.S. tax liability multiplied by a fraction the numerator of which is taxable income from sources outside the United States (after taking all relevant deductions) and the denominator of which is his worldwide taxable income.

The alternative limitation is the per-country limitation. Under this limitation the same calculation made under the overall limitation is made on a country-by-country basis. The allowable credits from any single foreign country cannot exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's taxable income from that country and the denominator of which is worldwide taxable income.

The provision repeals the per-country limitation. Taxpayers will be required to compute the limitation of the amount of foreign tax which can be used to reduce U.S. tax under the overall limitation. The effect of this provision is that losses from any foreign country will reduce income from other foreign countries for purposes of calculating the foreign tax credit limitation, and thus will reduce the amount of foreign taxes which can be used from those countries as a credit against U.S. tax. Foreign losses will reduce U.S. tax on U.S. income only in cases where foreign losses exceed income from all foreign countries for the taxable year.

Issue

The issue is whether transitional rules for the repeal of the per-country limitation should be provided in certain limited situations where substantial investments of capital have been made under the assumption that the foreign tax credit could be computed under the per-country limitation.

Explanation of provision

The basic provision eliminating the per-country limitation was in the House bill. In addition, the House bill contained two transitional rules, one relating to mining and one relating to business in Puerto Rico and possessions. The Finance Committee made no change in the modification reating to mining. It tightened up the provision relating to Puerto Rico and the possessions.

Certain existing mining ventures were begun with substantial investments of capital under the assumption that the foreign tax credit could be computed under the per-country limitation. The provision permits a limited transitional rule under which the per-country limitation may be used for years beginning before 1979 for domestic corporations (whether or not included in a consolidated return) which have, as of October 1, 1975, satisfied four conditions. The four conditions are that the corporation had as of October 1, 1975: (1) been engaged in the active conduct of the mining of hard minerals (of a character for which a percentage depletion deduction is allowable (under sec. 613)) outside the United States or its possessions for less than 5 years; (2) had losses from the mining activity in at least 2 of the 5 years; (3) derived 80 percent of its gross receipts since the date of its incorporation from the sale of the minerals that it mined, and (4) made commitments for substantial expansion of its mining activities.

A similar problem was presented with respect to certain ventures begun in Puerto Rico or other possessions and the provision applies the special transition period developed for mining ventures to existing ventures in Puerto Rico or other possessions. The House bill retained the per-country limitation in the case of income and losses from Puerto Rico and other possessions. Losses sustained on a per-country basis under this provision are subject to future recapture on a per-country basis.

The transitional rule relating to mining is believed to benefit the Freeport Minerals Company. Other mining corporations may also benefit. The provision relating to Puerto Rico and the possessions applies to PPG Industries, Inc.

Revenue effect

It is estimated that the transitional rules with respect to mining will reduce budget receipts by $12 million in fiscal year 1977, $10 million in fiscal year 1978, and $5 million in fiscal year 1979. It is estimated that transitional rule with respect to Puerto Rico and the possessions will reduce budget receipts by $6 million in fiscal year 1977, $5 million in fiscal year 1978, and $3 million in fiscal year 1979.

11. Recapture of Foreign Losses (sec. 1032 of the bill)

Present law and committee amendment

Present law permits taxpayers subject to U.S. tax on foreign source income to take a foreign tax credit for the amount of foreign taxes paid on income from sources outside of the United States. However, there are certain situations in which the present foreign tax credit system may indirectly result not only in a reduction of U.S. taxes on foreign source income previously subject to foreign tax, but also in a reduction of U.S. tax on U.S. source income not subject to foreign tax.

The provision provides for the repeal of the per-country limita-

tion, which will prevent a taxpayer who has foreign losses from reducing his U.S. tax on U.S. income if the taxpayer also has foreign income equal to or greater than the amount of losses. However, in a case where an overall foreign loss exceeds foreign income in a given year, the excess of the losses can still reduce U.S. tax on domestic source income. In this case, if the taxpayer later receives income from abroad on which he obtained a foreign tax credit, the taxpayer receives the tax benefit of having reduced his U.S. income for the loss year while not paying a U.S. tax for the later profitable year. To reduce the advantage to these taxpayers, the committee has included a provision which requires that in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses should, in effect, be recaptured by the United States when the company subsequently derives income from abroad.

In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources. The amount of the foreign income which is to be treated as income from domestic sources in a subsequent year is limited to the lesser of the amount of the loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for that year, or such larger percent as the taxpayer may choose. Thus, in any taxable year the amount subject to recapture is not to exceed 50 percent of the taxpayer's foreign income (before recharacterization) unless the taxpayer chooses to have a greater percentage of his foreign income so recharacterized. For purposes of the recapture provision, a "foreign loss" does not include foreign expropriation losses.

Issue

The issue is whether the loss recapture provisions should apply to losses sustained for tax purposes in taxable years beginning after the December 31, 1975, effective date in certain situations where the investments had become worthless prior to that date or their value was greatly reduced because of losses incurred prior to that date.

Explanation of provision

This provision was proposed by Senator Packwood. The loss recapture provisions do not apply in the case of a loss from the disposition of a bond, note, or other evidence indebtedness issued before May 14, 1976, by a foreign government or instrumentality thereof for property located in that country or stock or indebtedness of a corporation incorporated in such country. This provision is intended to provide relief where domestic corporations incur losses with respect to foreign subsidiaries because they were forced, under the threat of expropriation, to exchange their stock or assets for long-term debt obligations of a foreign government. This provision applies to Boise Cascade Corporation.

A second exception was proposed by Senator Talmadge. This exception is provided where an investment in the stock or indebtedness of a

corporation in which the taxpayer owned at least 10 percent of the voting stock is substantially worthless prior to the effective date but where the loss is not sustained for tax purposes until after the effective date if the taxpayer terminates its investment in the loss corporation or corporations by liquidating, selling or otherwise disposing its investment before January 1, 1977, and the loss corporation has suffered an operating loss in three out of the last five taxable years beginning before 1976 and sustained an overall loss for those five years. This provision applies to United Merchants and Manufacturing, Inc.

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

12. Transitional Carryback of Foreign Taxes on Oil and Gas Extraction Income (sec. 1035(a) of the bill)

Present law

Present law contains a limitation on the amount of foreign taxes with respect to foreign oil and gas extraction income which are allowable as a credit. This limitation was phased in beginning in 1975. The limitation is equal to 50.4 percent of the foreign oil and gas extraction income in 1976 and 50 percent of that income in 1977 and later years. Foreign taxes in excess of the limitation are not allowable as a credit in that year and cannot be carried forward or back to any other year.

Issue

The issue is whether during the phase-in period some carryforward or carryback provision is appropriate to deal with situations where timing differences between foreign tax systems and the U.S. tax system can result in a taxpayer having no foreign tax credits in some years in which the taxpayer has taxable income for U.S. tax purposes and having excess foreign tax credits in other years in which the taxpayer has little or no U.S. tax liability.

Explanation of provision

This provision is in the House bill and no change was made by the Senate Finance Committee. The provision permits a carryback to any taxable year ending in 1975, 1976, or 1977. The extraction taxes which may be carried back may offset only extraction income in the same country to which the extraction taxes were paid. The amount which may be carried back to any taxable year is limited to the net U.S. tax liability on the extraction income from that country for the year after taking into account any other foreign tax credits.

This provision affects Natomas and various small oil companies with operations in Indonesia.

Revenue effect

It is estimated that this provision will reduce corporate income tax liability for the year 1976 by $5 million, for the years 1977 and 1978, $10 million, and for the year 1979, $5 million.

13. Transitional Rule for Recapture of Foreign Oil-Related Losses (sec. 1035(b) of the bill)

Present law

Present law, as amended by the Tax Reduction Act of 1975, requires that the foreign tax credit be computed under a separate overall limitation for foreign oil-related income and that any foreign oil-related losses for taxable years ending after December 31, 1975, be recaptured in future years. The amount of losses to be recaptured in any year is the lesser of all prior unrecaptured losses or 50 percent of foreign oil-related income for the year.

Issue

The issue is whether any transitional rule should be provided for taxpayers who made investments in 1975 and earlier years with the anticipation that the losses arising in the early years of those investments (generally the first 3 to 5 years) would be allowed to reduce U.S. tax on U.S. income without being subject to full recapture under the provisions of present law.

Explanation of provision

This provision was proposed by Senator Curtis. The provision allows a taxpayer to recapture certain foreign oil-related losses over a longer period than under present law. The longer period applies only to a foreign oil-related loss which is sustained in a taxable year ending before January 1, 1979, and which was incurred pursuant to a binding contract to explore or to develop oil or gas property entered into on or before July 1, 1974. Under this provision, not more than 15 percent of the loss is recaptured for each of the first four taxable years beginning with the first year for which a foreign tax credit is claimed on foreign oil and gas extraction income. Thereafter, any remaining loss is recaptured in accordance with present rules.

This provision benefits Sun Oil Company.

Revenue effect

It is estimated that this provision will reduce budget receipts by $21 million in fiscal year 1977 and $6 million in fiscal year 1978. However, the reduction in those years will be recaptured by increased receipts in the following years.

14. Definition of Foreign Oil-Related Income (sec. 1035(c) of the bill)

Present law

Under present law, the amount of the foreign tax credits allowable for taxes paid with respect to foreign oil and gas extraction income is limited to 50 percent (50.4 percent in 1976) of that income. Any excess credits arising under this limitation can only be used to offset foreign oil-related income. Generally, oil and gas extraction income means

taxable income from the extraction of oil and gas and from the sale of assets used in such extraction activities. Foreign oil-related income includes taxable income from the extraction of oil and gas, the processing of oil and gas into their primary products, the transportation of the products, and the sale of assets used in such activities.

In addition, dividends and interest from a foreign corporation are included in foreign oil-related income. Foreign oil-related income also includes an allocable portion of dividends from a domestic corporation which earns oil-related income if such dividends are treated as foreign source income (because less than 20 percent of such corporation's gross income is derived from U.S. sources). However, interest from a domestic corporation earning foreign-oil-related income, which is likewise treated as foreign source income if less than 20 percent of its gross income is from U.S. sources, is not treated as oil-related income.

a. Interest paid by domestic corporations

Issue

The question is whether interest from domestic corporations should be treated differently than dividends from domestic corporations (and from interest or dividends from foreign corporations) for purposes of determining foreign oil-related income.

Explanation of provision

This provision was proposed by Senator Bentsen. The provision revises the definition of foreign oil-related income to include interest from a domestic corporation provided the interest is treated as foreign source income by reason of the fact that less than 20 percent of such corporation's gross income is derived from sources within the United States. As in the case of dividends included under present law, only the portion of the interest attributable to foreign oil-related income is included. The apportionment standards for foreign source income (sec. 862(b)) are to be used in making the allocation.

This provision affects many international oil companies (but not Aramco).

Revenue effect

It is estimated that the inclusion of interest in oil-related income will result in a decrease in budget receipts of $40 million in fiscal year 1977 and of $90 million thereafter.

b. Public utility income

Issue

The issue is whether income of a regulated public utility which has some activities relating to the transportation and distribution of natural gas should be subject to the separate overall limitation as foreign oil-related income.

Explanation of provision

This provision was proposed by Senator Curtis. The provision revises the definition of foreign oil-related income so that it does not include income from the transportation or distribution of natural gas by a regulated public utility for use within its own regulated public utility operations within the country in which it is incorporated and in which the regulated public utility is located.

This provision affects IU International Corporation.

c. Sale of stock in foreign corporation joining in consolidated return

Issue

The issue is whether income from the sale of stock in a foreign corporation earning foreign oil extraction income or foreign oil-related income should be treated in a manner similar to income from the sale of assets of the same foreign corporation in cases where the foreign corporation joins in the filing of a consolidated return with a U.S. corporation.

Explanation of provision

This provision was proposed by Senator Bentsen. The provision clarifies the definition of foreign oil-related income and foreign oil and gas extraction income in the case of the sale of stock of a foreign corporation entitled to be included as a member of a consolidated group. Since the income from such a corporation is included in the consolidated group for purposes of determining whether the income is foreign oil-related or foreign oil and gas extraction income, the sale of the stock is to receive the same treatment, to the extent the assets of the company whose stock is sold were used for the production of either foreign oil-related income or foreign oil and gas extraction income.

This provision benefits Tenneco, Inc.

15. Taxation of Foreign Oil-Extraction Income of Individuals (sec. 1035(d) of the bill)

Present law

Under present law, individuals are subject to the same limitation as corporations on the amount of foreign tax credits which can be claimed against foreign oil-extraction and foreign oil-related income. Individuals are thus limited to foreign tax credits equal to 50.4 percent of taxable extraction income in 1976 and 50 percent of taxable extraction income in 1977 and future years. Furthermore, any excess credits arising under this limitation can only be used to offset foreign oil-related income.

Issue

The issue is whether the 50-percent limitations is appropriate in the context of noncorporate taxpayers, since unlike corporations, the average tax rate of individuals may be lower or higher than the 48 percent rate.

Explanation of provision

This provision was suggested by Senator Fannin. The provision limits the allowable foreign tax credit on foreign oil and gas extraction income of individuals to the average U.S. effective rate of tax on that income. The provision achieves this result by establishing a separate overall foreign tax credit limitation for foreign oil and gas extraction income of taxpayers other than corporations.

This provision benefits the Clara Miller Trust and individuals on limited partnerships with the Hamilton Brother Corporation.

16. Creditable Taxes on Oil Payments Where No Economic Interest Exists (sec. 1035(e) of the bill)

Present law

Under present law, as amended by the Tax Reduction Act of 1975, no foreign tax credit is allowable for payments to a foreign country in connection with the purchase and sale of oil or gas where the taxpayer has no economic interest in the oil or gas and either the purchase or the sale is at a price which differs from the fair market price of the oil or gas. This provision was intended to deny any foreign tax credit to oil companies with respect to oil or gas which is owned by the foreign government (e.g., oil which is described as nonequity oil or buyback oil) where payments for the purchase of the oil owned by the foreign country are disguised in part as the payment of a tax.

Issue

The issue is whether taxpayers who have had an economic interest in foreign oil, but which have been forced into an altered arrangement so that they no longer have an economic interest in a particular oil field, should be subject to this provision without some provision for a transitional period.

Explanation of provision

This provision was suggested by Senator Hansen. The provision requires that section 901(f) is not to apply with respect to the purchase and sale of oil or gas from a field if the taxpayer has had an economic interest in the oil in that field and if, on or before March 29, 1975, the taxpayer has made an investment with respect to the field. This will be the case notwithstanding the fact that the taxpayer purchases the oil or gas from that field at less than the fair market value, including a discount which reflects compensation for the prior investment, or sells at a price which differs from the fair market value for the oil or gas. However, section 901(f) will apply in any case for taxable years beginning after 1985.

The provision does not apply to any field with respect to which no investment was made on or before March 29, 1975, even if the field is located within the same concession area as another field which is subject to the exception added by this provision. These investments will be subject to the test of the oil or gas being bought and sold at an arm's-length price.

This provision will affect the U.S. oil companies operating abroad which have been subject to nationalization and which do not have substantial excess foreign tax credits from other foreign countries. It has been reported that this provision will benefit Mobil Oil Company and other major oil companies operating in Iran.

Revenue effect

It is estimated that will result in a decrease in budget receipts of $34 million in fiscal year 1977 and of $40 million in each year thereafter through 1985.

17. Foreign Tax Credits Arising Through Oil and Gas Production Sharing Contracts (sec. 1035(f) of the bill)

Present law

Under present law, a foreign tax credit is allowable only for income, war profits, and excess profits taxes paid or accrued to a foreign country or to a possession of the United States. Amounts paid to a foreign government or a possession in other forms (such as royalty payments for the rights to develop natural resources) are allowed only as a deduction, even if designated by the foreign country as a tax. The service is given authority to determine what payments qualify as income taxes and thus are allowed as credits rather than as deductions.

Issues

Questions have arisen as to whether payments to a foreign government qualify as income taxes in the case of production sharing contracts. Under these agreements the government retains ownership of the mineral property while the oil company provides the services of drilling and producing the oil. The oil company is generally compensated for its costs by receiving the first production from the property, with the remainder of the production divided between the oil company and the foreign government according to negotiated percentages. Under these agreements part of the share of the production received by the foreign government (or by a government-owned entity which in turns makes payments to the foreign government) is designated as an income tax payment by the foreign government and claimed as a credit by the oil company.

The Internal Revenue Service recently issued Revenue Ruling 76–215, 1976 I.R.B. No. 23, holding that the contractor under a production-sharing contract in Indonesia is not entitled to a foreign tax credit for payments made by the government-owned company to the foreign government. The grounds for this holding were, in part, that since the foreign government already owns all of the oil and gas, there is no payment to the government by the contractor. Furthermore, even if a payment by, or on behalf of, the contractor could be identified, the IRS views such a payment as more in the nature of a royalty than a tax.

The issue is whether taxpayers should be allowed to continue to treat these payments as creditable taxes for a period of time while the production sharing arrangements with the Indonesian Government are renegotiated.

Explanation of provision

This provision was suggested by Senator Bentsen. The provision allows a limited foreign tax credit for a limited period in the case of production-sharing contracts to which Revenue Ruling 76–215 applies. Under this provision, amounts which are designated by a foreign government under certain production-sharing contracts as income taxes are treated as creditable income, war profits, and excess profits taxes even though the amounts would not otherwise be treated as creditable taxes. The provision only applies to taxes not creditable by reason of that ruling.

However, the total amount treated as creditable taxes under this provision is not to exceed the lesser of two amounts. The first amount

is the total foreign oil and gas extraction income with respect to production-sharing contracts covered under the rule multiplied by the U.S. corporate tax rate (generally 48 percent) less the otherwise allowable (if any) foreign tax credits attributable to income from those contracts. The second amount is the total foreign oil and gas extraction income multiplied by the U.S. corporate tax rate (generally 48 percent) less the total amount of the otherwise allowable foreign tax credits (if any) attributable to the total foreign oil and gas extraction income.

This provision will apply only to production-sharing contracts entered into before April 8, 1976, and will apply only with respect to taxes designated as having been paid under such contracts before January 1, 1982.

This provision affects Huffington Oil Company, Natomas Company, and a number of other small oil companies.

Revenue effect

It is estimated that this provision will decrease budget receipts by $23 million in fiscal year 1977 and $27 million in fiscal year 1978.

18. Source of Underwriting Income (sec. 1036 of the bill)

Present law

Under present law, the source of insurance underwriting income is unclear. Neither the Internal Revenue Code nor the Income Tax Regulations set forth a specific rule for determining the source of insurance underwriting income. It is the position of the Internal Revenue Service, however, that the source of such income is to be determined on the basis of where the incidents of the transaction which produce the income occur. Under this rule, income produced from insurance underwriting contracts negotiated and executed in the United States, regardless of the location of the insured risks, is generally deemed to be from sources within the United States. This rule apparently applies even though the insurance contract is actually written by a foreign company.

Issue

The source rule presently applied by the IRS to insurance underwriting income is vulnerable to artificial manipulation by taxpayers. By simply changing the place where a contract is negotiated and executed, a taxpayer can change the source of the underwriting income produced by the contract. That source rule in some situations also can result in double taxation. It is not uncommon for United States corporations doing business abroad through foreign subsidiaries to negotiate and execute insurance contracts in the United States which cover its overseas operations. The insurance policies, however, frequently must be issued in the foreign jurisdiction in which the insured's risk is located in order to comply with local insurance laws or for other business reasons. Although the underwriting income in these circumstances generally would be subject to foreign taxation, the income would be deemed United States source income, which in turn would reduce the amount of the foreign tax credit available to the taxpayer.

The issue is whether, in place of the source rule applied by the IRS, a new source rule should be adopted under which the source of insurance underwriting income would be the location of the risk insured.

Explanation of provision

This provision was suggested by Senator Fannin. The provision establishes that the source of insurance underwriting income is to depend upon the location of the risk. Underwriting income derived from the insurance of U.S. risks would be income from sources within the United States. All other underwriting income would be considered income from sources without the United States. The new source rule is not intended to change existing law with respect to the determination of whether foreign source income is effectively connected with the conduct of a trade or business within the United States.

This provision benefits the American International Group, Inc.

19. Third-tier Foreign Tax Credit Under Subpart F (sec. 1037 of the bill)

Present law

Under present law, when amounts which are foreign base company income are included in the income of a domestic corporation under subpart F, a proportionate part of the foreign taxes paid by the foreign corporation are deemed paid by the domestic corporation, and a foreign tax credit is available to the domestic corporation with respect to those taxes. These rules are substantially parallel to the foreign tax credit rules on actual distributions. However, this deemed-paid credit is available for subpart F income only if the controlled foreign corporation is a first-tier foreign corporation (which must be at least 10-percent owned by a domestic corporation) or a second-tier foreign corporation (which must be at least 50 percent owned by a first-tier foreign corporation).

Issue

The issue is whether the foreign tax credit rules with respect to amounts included in income under subpart F should be consistent with the rules applicable to dividends actually distributed.

Explanation of provisions

This suggestion was made by the staff in order to provide the same tax treatment under Subpart F as applies generally in the case of the foreign tax credit for third-tier subsidiaries. The provision makes two changes to the present rules for computing a foreign tax credit with respect to amounts included in income under subpart F. First, the amendment provides that the foreign tax credit is applicable with respect to foreign taxes paid by a third-tier foreign corporation whose undistributed income is taxed to the shareholder. Second, the amendment liberalizes the stock ownership test applicable to second-tier foreign corporations.

Under the provision, a foreign corporation qualifies as a second-tier foreign corporation if at least 10 percent of its voting stock is owned by a first-tier foreign corporation, at least 10 percent of the voting stock of which must be owned by a domestic corporation. A foreign corporation qualifies as a third-tier foreign corporation if at least 10 percent of its voting stock is owned by a second-tier foreign corporation.

This will affect any company with subpart F income which has a third-tier foreign subsidiary.

Revenue effect

This provision will reduce budget receipts by $4 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981.

20. Bank Deposits in the United States of Nonresident Aliens and Foreign Corporations (sec. 1041 of the bill)

Present law

Present law provides, in general, that interest, dividends and other similar types of income of a nonresident alien or a foreign corporation are generally subject to a 30-percent tax on the gross amount paid if such income or gain is not effectively connected with the conduct of a trade or business within the United States (secs. 871(a) and 881). However, a number of exemptions have been provided in the Code from this 30-percent tax on gross income including an exemption for interest derived from bank accounts.

In addition, various income tax treaties of the United States provide for either an exemption or a reduced rate of tax for interest and dividends paid to foreign persons if the income is not effectively connected with the conduct of a trade or business within the United States.

Issue

The question is whether the present exemption for bank deposit interest which would otherwise expire at the end of the year should be made permanent.

Explanation of provision

This is a House provision which was not changed by the Senate Finance Committee. The provision continues the exemption in present law for interest on deposits with persons carrying on the banking business without any termination date. The present exemption for interest of deposits expires for interest paid after December 31, 1976. The provision makes the exemption for interest on deposits permanent by eliminating the language of present law which would terminate the provision for interest paid after December 31, 1976.

This affects many banks, particularly those located near a U.S. border and those with significant international business.

Revenue effect

It is estimated that this provision will reduce budget receipts by $55 million in fiscal year 1977, $115 million in fiscal year 1978, and $145 million in fiscal year 1981.

21. Sales or Exchanges Giving Rise to Dividends (sec. 1042 of the bill)

Present law

Under present law, a distribution by a foreign corporation of appreciated property is treated in the same manner that similar distributions from a domestic corporation to an individual shareholder are treated. That is, the shareholder is treated as having received a dividend equal to the fair market value of the property and the distributing corporation reduces earnings and profits by the basis of the property distrib-

uted. Further, when a foreign corporation distributes the stock of a second-tier foreign corporation to its U.S. shareholders, the earnings and profits of the second-tier foreign corporation to the extent accumulated after 1962 will be subject to a tax as a dividend when such earnings are distributed or are treated as having been distributed to the U.S. shareholder. A recent court case has held that when the first-tier foreign subsidiary is liquidated, the earnings and profits available for dividend taxation are reduced by the basis in the second-tier subsidiary.

Issue

The issue is whether the earnings and profits of a foreign corporation are subject to possible double taxation when it distributes appreciated property, and, if so, should relief be provided notwithstanding contrary court cases or the running of periods of limitations for bringing refund claims.

Explanation of provision

This provision was suggested by Senator Hartke. The provision adds a special rule in the case of certain past liquidations of a foreign subsidiary which entitles the taxpayer to apply the new provisions of the law and obtain a refund or a credit of any overpayment by reason of the application of the new provisions notwithstanding the fact that the refund or overpayment would otherwise be prevented by a court case or the statute of limitations. If a refund or a credit is allowed, however, no interest is to be paid on the refund or credit for any period prior to the date of enactment.

The situation provided for in the provision covers the case where a foreign subsidiary is liquidated by its U.S. parent and in an earlier year stock of a lower-tier foreign subsidiary was distributed to the parent as a dividend. Since the stock of the lower-tier subsidiary is stock described in section 1248, the accumulated earnings with respect to that stock are still subject to dividend treatment upon the sale or exchange of the stock at a gain. This, in effect, could result in double taxation of those earnings. Thus, the provision requires that the Secretary of the Treasury in promulgating his regulations under section 367(b) write the rules dealing with the computation of earnings and profits and basis of stock in such a manner so that double taxation is avoided.

This provision benefits the H. H. Robertson Company.

22. Contiguous Country Branches of Domestic Life Insurance Companies (sec. 1043 of the bill)

Present law

Under present law, a domestic mutual life insurance company is subject to tax on its worldwide taxable income. If the company pays foreign income taxes on its income from foreign sources it is allowed a foreign tax credit against its otherwise payable U.S. tax on foreign source income.

Issue

As a general rule, profits of a U.S. company although earned from sources outside the United States should be subject to U.S. tax when earned since those profits are available for distribution to the shareholders of the company or are available to the company to be used within or without the United States for new investments. However,

the profits derived by a Canadian branch of a U.S. mutual life insurance company are not generally available for use other than as reserves and surplus of the Canadian policyholders and may not be used to provide insurance for the U.S. policyholders. The issue is whether this feature of mutuality, in which the earnings are restricted to benefit the Canadian policyholders, distinguishes the branch operations of a mutual life insurance company from the branch operations of other businesses.

Explanation of provision

This provision was in the House bill and only minor changes were made in it by the Senate Finance Committee.

Mutual companies.—The provision establishes a special system for branches of U.S. mutual life insurance companies which are operated in a contiguous country (i.e., Canada or Mexico). To be eligible for this special treatment a mutual life insurance company must make an election with respect to a contiguous country life insurance branch.

If a proper election is made there is excluded from each item involved in the determination of life insurance company taxable income the items separately accounted for in a separate contiguous country branch account which the mutual life insurance company is required to establish and maintain under the bill.

For purposes of this provision, a branch is a contiguous country life insurance branch if it satisfies three conditions. First, it must issue insurance contracts insuring risks in connection with the lives or health of residents of a country which is contiguous to the United States (i.e., Canada or Mexico). Second, the branch must have its principal place of business in the contiguous country for which it insures risks. Third, the branch, if it were a separate domestic corporation, must be able to qualify as a separate mutual life insurance company.

The election to establish a separate contiguous country branch is to be treated as a taxable disposition for purposes of recognizing any gain by the domestic company. If the aggregate fair market value of all the invested assets and tangible property which is separately accounted for by the company in the branch account exceeds the aggregate adjusted basis of those assets (for purposes of determining gain) then the company is to be treated as having sold those assets on the first day of the first taxable year for which the election is in effect at the fair market value on that day. The net gain on the deemed sale of these assets is to be recognized notwithstanding any other provision of the Code.

The provision also contains rules for the taxation of the contiguous country branch income if it is ever repatriated. First, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are to be taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of

the domestic company they are to be added to the life insurance company taxable income of the domestic company except to the extent the transfers are reimbursements for home office services.

The election provided by this provision may be made for any taxable year beginning after December 31, 1975. Once an election is made it is to remain in effect for all subsequent years except that it may be revoked with the consent of the Secretary.

Transfers by stock companies.—The provision also establishes a special rule in the case of stock life insurance companies operating in Canada or Mexico. While it is easier for a stock life insurance company to operate through a subsidiary organized under foreign law than it is for a mutual company, problems would be encountered in transferring an existing business to a foreign subsidiary since such a transfer would require the satisfaction of the Secretary that one of its purposes was not the avoidance of Federal income taxes. Since the provision contains special rules for deemed transfers in the case of mutual life insurance companies, the committee felt it was appropriate to provide similar rules in the case of actual transfers by stock companies to a contiguous country subsidiary.

Under the provision a domestic stock life insurance company which has a contiguous country life insurance branch may elect to transfer the assets of that branch to a foreign corporation organized under the laws of that contiguous country without the application of section 367 or 1491. The insurance contracts which may be transferred to the subsidiary include only those of the types issued by a mutual life insurance company.

The provision requires that the net gain on the transfer be subject to tax. To the extent that the aggregate fair market value of all the invested assets in tangible property which are separately accounted for in the contiguous country life insurance branch exceeds the aggregate adjusted basis of all of these assets for purposes of determining gain, the domestic life insurance company is to be treated as having sold all of the assets on the first day of the first taxable year for which the election is in effect.

This provision also provides that the stock of the subsidiary for purposes of determining the income tax of the domestic stock life insurance company is to be given the same treatment as is accorded the assets of a contiguous country branch of a mutual company under the mutual company provision. Similarly, any dividends paid by the subsidiary to the domestic life insurance company will be added to its life insurance company taxable income.

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

These provisions affect both mutual and stock companies with operations in Canada.

Revenue effect

It is estimated that the mutual and stock company provisions will result in a decrease in budget receipts of $4 million in fiscal year 1977 and of $8 million thereafter.

23. Transitional Rule for Bond, Etc., Losses of Foreign Banks (sec. 1044 of the bill)

Present law

The Tax Reform Act of 1969 (Public Law 91–172) eliminated the preferential treatment accorded to certain financial institutions for transactions involving corporate and government bonds and other evidences of indebtedness. Previous to that legislation these financial institutions were allowed to treat net gains from these transactions as capital gains and to deduct the losses as ordinary losses. The 1969 Act (sec. 433, amending sec. 582 of the Code) provided parallel treatment to gains and losses pertaining to these transactions by treating net gains as ordinary income and by continuing the treatment of net losses as ordinary losses. The ordinary income and loss treatment provided under the 1969 Act was also applied to corporations which would be considered banks except for the fact that they are foreign corporations. Previous to the 1969 Act, these corporations had treated the above-described transactions as resulting in either capital gains or capital losses.

Issue

Some of the corporations which would be considered banks except for the fact that they are foreign corporations had capital loss carryovers predating the 1969 Act. However, any post-1969 gains realized by these corporations resulting from the sale or exchange of a bond, debenture, note, or other evidence of indebtedness is accorded ordinary income treatment. Thus, these corporations are left with capital loss carryforwards which, under present law, cannot be applied against any gains resulting from the same type of transactions which previously generated such losses.

Explanation of provision

This provision was added by the House and no change was made in it by the Senate Finance Committee. The provision establishes a special transitional rule for corporations which would be banks except for the fact that they are foreign corporations. Net gains (if any) for a taxable year on sales or exchanges of bonds, debentures, notes, or other evidences of indebtedness are considered as gain from the sale or exchange of a capital asset to the extent that such gain does not exceed the portion of any capital loss carryover to the taxable year where such capital loss is attributable to the same types of sales or exchanges for taxable years beginning before July 12, 1969. In addition, a refund or credit of any overpayment as a result of the application of the provision is not precluded by the operation of any law or rule of law (other than section 7122, relating to compromises) so long as the claim for credit or refund is filed within one year after the date of the enactment of the provision.

The provision applies to taxable years beginning after July 11, 1969.

This provision will have general application to foreign banks with U.S. business. The Royal Bank of Canada has supported the provision.

24. Western Hemisphere Trade Corporations (sec. 1052 of the bill)

Present law

Present law provides that an affiliated group filing a consolidated return is permitted to average the foreign source income and foreign taxes of any Western Hemisphere trade corporations ("WHTCs") included in the group with the foreign source income and foreign taxes of non-WHTCs included in the group if both derive their income from the same country and the per-country foreign tax credit limitation is used. However, except in the case of a public utility, the averaging of foreign income and taxes of WHTCs and non-WHTCs is not allowed if the overall foreign tax credit limitation is elected.

Issue

The bill generally would repeal both the per-country limitation and the WHTC provisions. The issue is whether there are circumstances under which affiliated groups thus required to use the overall limitation should be permitted to average the foreign income and taxes of WHTCs and non-WHTCs during the four-year phase-out period of the WHTC provisions.

Explanation of provision

This provision was suggested by Senator Curtis. The provision permits a foreign corporation which is treated as being a domestic company for consolidated return purposes to average its foreign taxes with other corporations in the group if they each derive 95 percent or more of their gross income from sources within a contiguous country and are primarily engaged in mining and related transportation in that contiguous country.

This provision is applicable to taxable years beginning during the years 1976 through 1979, the four year phase-out period of the WHTC provisions.

This provision affects the Hanna Mining Company.

25. Treatment of Certain Individuals Employed in Fishing As Self-Employed Individuals (sec. 1207 of the bill)

Present law

Under the present law, the Internal Revenue Service usually treats individuals employed on fishing boats, or on boats engaged in taking other forms of aquatic animal life, as regular employees. As a result, operators of the boats must withhold taxes from the wages of these crewmen, and must also deduct and pay the taxes on employees and employers under the Federal Insurance Contributions Act (the social security taxes).

Issue

The issue is whether fishing boat crewmen whose sole remuneration is a share of the catch should be treated as regular employees or as self-employed.

Explanation of provision

This provision was suggested by Senator Hathaway. The provision established provides that boat crewmen, under certain circumstances, shall be treated as self-employed for purposes of income tax withhold-

ing from wages, the self-employment tax, the Federal Insurance Contributions Act taxes, and the social security laws. Crewmen are to be treated as self-employed if their only remuneration is a share of the boat's catch, or, in the case of an operation involving more than one boat, is a share of the catch of the entire fleet, provided that the operating crew of their boat is normally made up of fewer than 10 individuals.

To achieve this, the provision amends the definitions of employment (sec. 3121(b) of the Code), the definition of a trade or business (sec. 1402(c)), and the definition of wages for purposes of withholding (sec. 3401(a)). In addition, amendments are made to the definitions of employment and of a trade or business in the parallel social security statutes.

This provision alleviates many of the recordkeeping requirements of the small boat operators. However, in order to permit the Internal Revenue Service to maintain a method of insuring that the crewmen to be treated as self-employed correctly report their income, the provision also requires boat operators to report the identity of the self-employed individuals serving as crewmen, as well as the portion of the catch allotted to that individual. In addition, in order to allow the Service to compute the total proceeds of the catch, if necessary, the boat operator is also to report the percentage of his own share of the catch. Furthermore, such a boat operator is also to provide each of the self-employed crewmen a written statement on or before January 31 of the succeeding year showing the information reported by the boat operator with respect to that crewman for the preceding calendar year.

The provisions providing for tax treatment of crewmen as self-employed when employed under the circumstances described above are to be effective with respect to services performed after December 31, 1971, in taxable years ending after that date. The provisions pertaining to the new reporting requirements of boat operators apply to calendar years beginning after December 31, 1976.

The provision covers situations where the operating crew of the boat upon which the crewmen serve consists of fewer than ten individuals, and the sole remuneration of these crewmen consists of a share of the catch of the boat, or, in the case of an operation involving more than one boat, consists of a share of the catch of the entire group of boats. it is estimated that this provision will decrease budget receipts by $65 million over the next five fiscal years.

This provision will benefit many small fishing operations, including those in New England.

26. Tax Treatment of Certain 1972 Disaster Loans (sec. 1303 of the bill)

Present law

Under present law (sec. 165), taxpayers are generally allowed to deduct their losses sustained during the taxable year, including losses attributable to fire, storm and other casualty, to the extent that such losses are not compensated for by insurance or otherwise.[1] In the case of any loss attributable to a major disaster which occurred in

[1] Individuals generally are allowed to deduct their losses of property (not connected with their trade or business) only to the extent that the loss exceeds $100; losses attributable to an individual's business are fully deducible.

an area authorized by the President to receive disaster relief, a special rule allows the loss, at the election of the taxpayer, to be deducted on the return for the year immediately preceding the year of the disaster (that is, the loss may be deducted on the return which is generally filed in the year in which the disaster occurs). In a case where a deduction resulting from a loss is claimed in one year, and compensation is paid with respect to that loss in a later year, the amount of compensation is generally required to be taken into income by the taxpayer under the tax benefit theory.

Issue

Certain cases arising in the past have come to the attention of the committee in which individuals who were hard hit by disasters, such as flood, claimed a deduction with respect to the disasters, unaware, in many cases, that they might later receive compensation, or partial compensation, for their loss. In some instances, the compensation may be received in a year for which the taxpayer is in a higher tax bracket than he was in for the year for which the disaster loss deduction was claimed. As a result, the taxpayer may be required to pay more tax, with respect to the compensation or reimbursement, than would have been owing if he had not claimed the deduction in the first place. The issue is whether such tax treatment is appropriate under these circumstances.

Explanation of provision

This is a House provision in which the Senate Finance Committee made no change. The provision requires that, under certain circumstances, in the case of a loss attributable to a disaster which occured in 1972, in an area designated by the President as a disaster relief area, the tax on the first $5,000 of compensation received with respect to that loss is not to exceed the tax which would have been payable if the $5,000 (or lesser) deduction had not been claimed. This treatment applies only if the taxpayer elects to come under these provisions, in a time and manner to be prescribed in regulations, and is subject to certain conditions.

In order for the taxpayer to elect the benefits of this provision, he must have suffered a disaster loss for the year 1972, and to be fully eligible under this provision his adjusted gross income for the year in which he claimed the disaster loss as a deduction (either 1972 or 1971, as the case may be) cannot have exceeded $15,000 ($7,500 in the case of a married individual filing a separate return). In those cases where an individual who is otherwise eligible under this provision has adjusted gross income in excess of $15,000 (or $7,500, whichever applies), the $5,000 limit is to be reduced dollar-for-dollar to the extent his adjusted gross income exceeds $15,000.

This provision is intended primarily to benefit certain taxpayers who suffered flood losses in Pennsylvania, South Dakota, and West Virginia.

This provision shall apply to payments received after December 31, 1973, in taxable years ending after such date.

Revenue effect

This provision will reduce budget receipts by $45 million in the transition period, $15 million in fiscal year 1977, $15 million in fiscal year 1978, and less than $15 million in fiscal year 1979.

27. Tax Treatment of Certain Debts Owed by Political Parties to Accrual Basis Taxpayers (sec. 1304 of the bill)

Present law

Under present law, any deduction generally allowable for bad debts (sec. 166) or for worthless securities (sec. 165(g)) is not allowed for a worthless debt owned by a political party. This provision applies to all taxpayers other than a bank (as defined in sec. 581), but where the debt arises out of the sale of goods or services, the provision affects only taxpayers utilizing the accrual method of accounting (because only these taxpayers would have taken into income the receipts which give rise to the debt).

The provision in present law defines political parties to include all committees of a political party and all committees, associations, or other organizations which accept contributions or make expenditures on behalf of any individual in any Federal, State or local election.

Issue

The question is whether or not the concern which gave rise to the provision in present law (i.e., that businesses will make concealed contributions to compaigns by providing services and not collecting the resulting debts) should be overridden in some cases where taxpayers in the business of providing services to campaigns have debts which cannot be collected.

Explanation of provision

This provision was in the House bill but that version of the bill applied retroactively to open years. The Finance Committee made this provision applicable only to years beginning after 1975.

The provision adds an exception to the provision disallowing a deduction for bad debts owed by political parties. The exception applies only to taxpayers who use the accrual method of accounting. These taxpayers are to be allowed a bad debt deduction with respect to debts which are accrued as a receivable in a *bona fide* sale of goods or services in the ordinary course of their trade or business.

This exception is limited to those cases in which 30 percent of all of the receivables accrued in the ordinary course of all of the trades or businesses of the taxpayer are due from political parties. Thus, the exception is limited to those taxpayers whose sales to political parties (including political campaigns and candidates) constitute a major portion of their trades or businesses.

Furthermore, the bad debt deduction is to be allowed only if the taxpayer has made substantial continuing efforts to collect on the debt. Thus, a taxpayer must make good faith efforts over a period of time to collect the debt and must be able to document those efforts.

It has been stated that the retroactive feature of this provision would have applied at least to companies owned by Mr. Guggenheim and Mr. Dierdorf. With prospective application only, this provision

would apply to any person an the accrual method of accounting who has outstanding bad debts from political parties or political campaigns.

28. Prepublication Expenses (sec. 1305 of the bill)

Present law

Present law (sec. 174(a)(1)) permits, under certain circumstances, an itemized deduction for research and experimental expenditures otherwise chargeable to a taxpayer's capital account. The regulations under this provision define research and experimental expenditures as expenditures incurred in connection with a taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The regulations specifically exclude expenditures for research in connection with literary, historical, or similar projects.

In Rev. Rul. 73–395,[1] the Internal Revenue Service held that the costs incurred by an accrual basis taxpayer in the writing, editing, design and art work directly attributable to the development of textbooks and visual aids do not constitute research and experimental expenditures under section 174. The Service further held that these costs cannot be inventoried (under sec. 471) but instead represent expenditures that must be capitalized (under sec. 263) and may be depreciated (under sec. 167(a)).

However, the ruling also stated that expenditures incurred in the actual printing and publishing of textbooks and visual aids should be inventoried (under sec. 471) with a part of the costs being apportioned to books and visual aids still on hand at the end of the taxable year. Also, expenditures for manuscripts and visual aids that are abandoned may be deductible as losses (under sec. 165).

On March 17, 1976, the Internal Revenue Service announced [2] that it had begun a study project as a result of questions regarding the application of Rev. Rul. 73–395 to certain prepublication expenses of the publishing industry. The Service will study the application of sections 162 (dealing with the deduction of trade or business expenses), 263 (treatment of capital expenditures), and 471 (general rule for inventories) to prepublication costs within different segments of the industry.

The Service stated that the application of these sections is not adequately explained in Rev. Rul. 73–395, and that the project is expected to result in the publication of regulations and/or additional revenue rulings. It is also likely that Rev. Rul. 73–395 will be modified and clarified or superseded.

Pending completion of this project, the Service is suspending audit and appellate activity with respect to cases in which the deductibility of these prepublication expenses of publishers is an issue. No further action will be taken in these cases except as necessary to protect the interest of the Government.

In the case of authors, the Internal Revenue Service requires capitalization (under sec. 263) of prepublication travel and research expenditures incurred while researching, writing, and arranging material for a book. These expenditures are treated as capital items because they do not qualify as deductible research and experimental expenditures

[1] 1973–2 C.B. 87.
[2] Press Release IR–1575.

under the regulations for section 174 and because the Service considers them amounts expended for securing a copyright which must be capitalized under the regulations for section 263.

Under section 167, these expenditures may be depreciated over their useful lives. If the actual useful life of a copyrighted work can be estimated, that period is used for determining the depreciation rate. Otherwise the 28-year copyright term is used.

A decision of the United States District Court, Central District, California,[3] however, held that a taxpayer, found to be in the business of writing, could deduct as ordinary and necessary business expenses (under section 162(a)) the expenses incurred for meals, lodging and travel while researching, writing, and arranging material for a book. The court explicitly held that the writer's expenditures were not expenses incurred for the production of a book by one not in the trade or business of writing; nor were they expenses incurred for securing a copyright. In Rev. Rul. 73–395, the Service announced that it would not follow this judicial decision.[4]

Issue

The issue is whether the tax accounting practices of publishers and authors are to be sanctioned by enacting this provision which would suspend the Service's enforcement of its interpretation of the relevant tax law and which would permit publishers and authors to continue their customary practices until new regulations are issued, regardless of whether or not such practices followed the tax law, particularly with regard to section 174 and the regulations and rulings under that section.

Explanation of provision

The House bill contained a provision relating to the prepublication expenses of publishers. Senator Bentsen suggested certain modification in this provision. Its extension to cover authors was suggested by Senator Ribicoff.

The provision generally allows publishers and authors to continue their customary treatment of prepublication expenditures without regard to Rev. Rul. 73–395 and provides for new regulations. The provision is substantially the same as the provision in the House bill, except that it extends its application to authors.

The prepublication expenditures affected by the provision are those paid or incurred in connection with the taxpayer's trade or business of publishing or writing for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid, or similar product.

The provision allows taxpayers to treat their prepublication expenditures in the manner in which they have been treated consistently by the taxpayer in the past until new regulations are issued with regard to these expenditures after the date of enactment of the bill.

Any regulations issued by the Internal Revenue Service would apply only to taxable years beginning after their issuance. Until these regu-

[3] *Stern* v. *United States*, 1971-1. U.S.T.C. 9375. The case involved two issues: (1) whether the taxpayer was engaged in the business of writing, and (2) whether traveling expenses were deductible as ordinary and necessary business expenses or constituted non-deductible expenditures for the improvement of a capital asset.

[4] The Government said that it did not appeal the case because it had erroneously stipulated to the effect that "If the taxpayer was determined to be in the business of being a writer, the traveling expenses in question were ordinary and necessary."

lations are issued, the Internal Revenue Service would administer the application of sections 61, (as it relates to cost of goods sold) 162, 174, 263 and 471 to the prepublication expenditures of both publishers and authors without regard to Rev. Rul. 73–395. In addition, as indicated above, the Service would administer these sections in the same manner as they were consistently applied by taxpayers prior to the issuance of Rev. Rul. 73–395. If a taxpayer did not consistently follow a specific tax accounting method, his returns would be treated by the Service in accord with usual administrative procedures.

The Encyclopedia Britannica initially requested the amendment benefiting publishers. An ad hoc committee formed by some other members of the publishing industry has also supported this provision. Both the Encyclopedia Britannica and the ad hoc committee also sought administrative suspension of Rev. Rul. 73–395. The modifications added by the Senate Finance Committee were recommended by the "San Antonio Light," among others.

Only publishers who have deducted prepublication expenses currently would benefit from the bar against IRS application and enforcement of the Service's interpretation that the law requires that such expenses be capitalized. Publishers who have capitalized such expenses would not benefit from this provision.

The amendment affecting authors was requested by The Authors League of America, Inc., New York, New York. The authors' amendment would apply to all professional writers.

Any regulations issued by the Service on publishers' or authors' prepublication expenditures after the date of enactment will apply prospectively only to taxable years beginning after their issuance.

The provision will have little or no revenue effect because publishers and authors benefitted by the suspension of Rev. Rul. 73–395 would have neither reported nor paid the past tax liabilities assessed by the Service pursuant to its interpretation of the law as stated in that ruling. However, if the Service had not suspended audit and appellate activity in cases arising from its legal interpretation as evidenced in Rev. Rul. 73–395, and if no legislative bar on enforcement were enacted, publishers' past due tax liabilities could amount to several hundred million dollars. Any change in authors' liabilities probably would be negligible.

29. Treatment of Face Amount Certificates (sec. 1307 of the bill)

Present law

In general, present law (sec. 1232) provides that the amount of discount that arises where a corporation issues a bond, debenture, note, certificate or other evidence of indebtedness for a price less than the face amount payable at maturity is treated as ordinary income. The Tax Reform Act of 1969 amended this provision to provide that the discount attributable to a bond, note, certificate or other evidence of indebtedness issued by a corporation after May 27, 1969, is to be included in the holder's income on a ratable basis over the term of the obligation.

In 1971, the Internal Revenue Service issued regulations under section 1232 interpreting the changes made by the Tax Reform Act of 1969. These regulations provided that certain deposit arrangements

with financial institutions made on or after January 1, 1971, which arrangements provide that interest will be deferred until maturity (i.e., certain certificates of deposit, time deposits, bonus plans, etc. issues by banks and similar financial institutions) are subject to the ratable inclusion rules under section 1232. Under these regulations, the application of section 1232 to face-amount certificates (as defined in section 2(a)(15) of the Investment Company Act of 1940) was reserved.[1]

Subsequently, on October 9, 1973, the Internal Revenue Service proposed further regulations which provided that a face-amount certificate issued by a corporation after March 31, 1974, would be subject to the ratable inclusion rules under section 1232. These regulations were issued in final form on March 29, 1974, applicable to face-amount certificates issued after December 31, 1974. The application of these regulations was subsequently postponed by the Internal Revenue Service on two separate occasions in order to provide Congress an opportunity to clarify its views as to the appropriate tax treatment in these cases. Pursuant to the latest postponemnnt, a face-amount certificate issued by a corporation after December 31, 1975, is subject to the ratable rules under section 1232. Thus, under these regulations the amount of any original issued discount attributable to a face-amount certificate issued after December 31, 1975, must be included in the gross income of the holder on a pro rata basis over the term of the certificate. The amount that must be ratably included in gross income is the difference between the amount paid by the purchaser and the amount received by him at maturity. Further a corporation issuing a face-amount certificate after December 31, 1975, must amortize the discount over the life of the certificate.

On November 26, 1975, Investors Syndicate of America (I.S.A.), a corporation that issues face-amount certificates, filed an action for a declaratory judgment that these regulations, relating to face-amount certificates be declared invalid. This suit is currently pending in the United States District Court for the District of Columbia.

On December 23, 1975, an action seeking a temporary restraining order and a preliminary injunction to enjoin the enforcement of these regulations was filed by Huntoon Paige & Company, Inc., and Association for Investment in United States Guaranteed Assets, Inc., in the U.S. District Court for the Southern District of New York. On December 30, 1975, the Court denied the plantiff's request and dismissed the action.

Issue

The issue is whether original issue discount attributable to a face-amount certificate should be included in the gross income of the holder ratably over the term of the certificate or included at the time of actual receipt (usually at the maturity of the certificate).

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[1] Under section 2(a)(15) of the Investment Company Act of 1940, a "face-amount certificate means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the "installment type"); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate).

Explanation of provision

This provision was suggested by Senator Mondale. The provision amends present law (sec. 1232(d)) to provide that face-amount certificates are not subject to the rules under section 1232, but rather are to be taxed under section 72. As a result, the amount of discount attributable to a face-amount certificate would not be ratably included in the gross income of the holder over the term of the certificate. Instead, the amount of discount would be included in the gross income of the holder upon actual receipt by him either at maturity or upon a premature cancellation. If the holder exercises an option to take annual payments from the corporation in lieu of a lump sum at maturity, the payments will be taxed like annuities are presently taxed under section 72, i.e., a portion of each payment received would be included in gross income and the portion attributable to the consideration furnished would be excluded.

The corporation issuing the certificate would be entitled to an interest deduction in each taxable year equal to the amount of discount accruing within that taxable year.

The provisions apply to a face-amount certificate as defined in section 2(a)(15) of the Investment Company Act of 1940.

The amendment would apply to face-amount certificates issued after December 31, 1975.

The provision primarily benefits Investors Diversified Syndicate.

Revenue effect

It is estimated that enactment of this provision will reduce tax liability by less than $100,000 in 1976, $150,000 in 1977, and about $500,000 in 1979.

30. Income From Lease of Intangible Property as Personal Holding Company Income (sec. 1308 of the bill)

Present law

Under present law, a corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and at least 60 percent of the corporation's adjusted ordinary gross income comes from certain types of income.

Under present law, amounts which a corporation receives from renting or leasing corporate property to a 25 percent or larger shareholder are treated as personal holding income, but only if the corporation derives over 10 percent of its total income from other types of personal holding company income (sec. 543(a)(6)). The Internal Revenue Service has published a revenue ruling holding that amounts which a corporation receives for leasing intangible property (such as a license to use or distribute a secret process or trade brand) to such a shareholder are to be treated as ordinary royalty income and not as income tested under section 543(a)(6) (Rev. Rul. 71-596). Consequently, the full amount of the license payments becomes personal holding company income in the category of "royalties" (sec. 543(a)(1), regardless of how much income of other types the corporation may have.

Issue

The issue is whether, if intangible property is licensed to a shareholder and used in an active trade or business, the corporation's income is closer to a rental situation and should be governed by the rule relating to use of property by a shareholder rather than by the rule for ordinary royalties. In other words, should amounts received from a license of a patent or other intangible property to a 25 percent or greater shareholder be personal holding company income only if over 10 percent of the corporation's total income is derived from other personal holding company income sources?

Explanation of provision

This provision was proposed by Senator Talmadge at the request of Senators Sparkman and Allen. The provision requires that amounts received under a lease of intangible personal property to a 25 percent or greater shareholder are to be governed by the rule that now applies to a corporate lease of tangible property to such a shareholder. Under this rule, the full amount received by the corporation for the shareholder's use of such property is not automatically treated as personal holding company income. Whether such income is treated as personal holding company income depends on whether the corporation derives more than 10 percent of its total income from other personal holding company sources.

The provision imposes a limitation, however, so that payments received from a lease of intangible property to a shareholder are to be tested under section 543(a)(6) only if the intangible assets are part of an integral group of assets consisting of tangible and intangible assets which the shareholder uses in actively carrying on his trade or business. If the shareholder does not use the license or other intangible asset (along with tangible assets) in carrying on his business, the license payments received by the corporation are to be treated as ordinary royalties governed by the present rules of section 543(a)(1) or, if appropriate on the facts, under other rules relating to mineral, oil or gas royalties (sec. 543(a)(3)) or copyright royalties (sec. 543(a)(4)).

The amendment to the general rule of section 543(a)(6) relating to intangible property is effective for corporate taxable years ending after December 31, 1964.

This provision affects the Montgomery Coca Cola Bottling Company.

31. Excise Tax on Parts for Light-Duty Trucks and Buses (sec. 1310 of the bill)

Present law

The Revenue Act of 1971 repealed the 10-percent excise tax on light-duty trucks and buses (those with gross vehicle weight of 10,000 pounds or less). As a result, truck and bus parts and accessories sold by the vehicle manufacturer as part of (or in connection with the sale thereof) a light-duty truck or bus are not subject to tax—neither the 10-percent tax that used to be imposed on the vehicle, nor the 8-percent tax on truck parts and accessories. Also, if a truck parts or accessories manufacturer sells parts or accessories to a manufacturer of light-duty trucks for use in "further manufacture" of those trucks, the parts and accessories are not subject to tax. However, if the truck parts manu-

facturer sells parts separate from the light-duty trucks and the installation of these parts by a retail truck dealer technically is not "further manufacture" of the trucks, then the manufacturer's excise tax of 8 percent applies. This is so even though the part or accessory is sold to the retail customer at the same time he purchases the tax-exempt light-duty truck or bus.

Issue

The issue is whether truck or bus parts sold separately by a manufacturer to a retail dealer for installation on an exempt light-duty truck or bus at the time of its retail sale should bear the 8-percent excise tax when the sale of such a part would be exempt if made to a truck manufacturer for inclusion on a "light-duty" truck.

Explanation of provision

This provision was presented by Senator Talmadge. It provides that the 8-percent manufacturers excise tax on trucks or bus parts and accessories is to be refunded or credited to the manufacturer in the case of any part or accessory sold on or in connection with the first retail sale of a light-duty truck or bus. Thus, those parts and accessories are to be effectively treated the same as the parts and accessories that actually are a part of the tax-exempt truck as delivered from the manufacturer. The credit or refund is not intended to cover replacement parts even if ordered at the time of the purchase of the truck, but only those parts and accessories which are to have original use on the purchased truck. The House bill contains no comparable provision.

This provision is to apply to parts and accessories sold after the date of enactment. (The Committee Report incorrectly states that it applies to parts sold on or after July 1, 1976.)

The beneficiaries of this provision would be purchasers of light duty trucks and buses.

Revenue effect

This provision is estimated to result in annual revenue losses of about $3 million. This revenue would otherwise go into the Highway Trust Fund (through September 30, 1979).

32. Certain Franchise Transfers (sec. 1311 of the bill)

Present law

Section 1253, which was added to the Internal Revenue Code by the Tax Reform Act of 1969, provides generally that the transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

Gain which would be treated as ordinary income pursuant to section 1253 (unlike gain which would be treated as ordinary income under other sections of the Code, e.g., sections 1245, 1250, 1251, and 1252), is not treated as an "unrealized receivable" of a partnership which would have the effect of causing ordinary income upon certain partnership distributions, payments in liquidation of a partnership interest, or sales of other dispositions of partnership interests.

Section 1253 applies to all transfers taking place after December 31, 1969. Unlike certain other provisions of the 1969 Act, no exception was

made for transfers occurring after December 31, 1969, pursuant to contracts which were in effect prior to that date.

Issues

The first issue is whether the rules providing ordinary income treatment for certain transfers of rights under a franchise, trademark or trade name should also apply to partnership transactions involving a shift in ownership of such rights.

The second issue is whether a transitional rule should be provided whereby transfers made after 1969 pursuant to contracts in existence before that time should be exempted from section 1253.

Explanation of provision

This provision was presented by Senator Bentsen. The provision requires that, with respect to certain partnership distributions, sales of partnership interests, and distributions in liquidation of partnership interests, the term "unrealized receivable" is to include the ordinary income element which would have been recognized had the partnership transferred a franchise, trademark, or trade name.

The provision also contains special transitional rules which provide that section 1253 will not apply to a transfer of a franchise, trademark or trade name if (1) the transfer is pursuant to a contract that was in existence prior to January 1, 1970, (2) the contract relates to a trade or business in which a professional practice is involved, and (3) the transfer is made to a person who immediately before the transfer is an employee or partner of the transferor. This rule is intended to allow certain owners of professional practices who, prior to 1970, had made arrangements to transfer their practices to employees or partners not to have the provisions of section 1253 apply to such transfers. However, in determining whether the transferor is entitled to capital gain treatment on such a transfer, the transfer will be subject to the ordinary rules of law relating to whether there had been a "sale or exchange" of a "capital asset". This new transitional rule is to apply in cases where there is a contract to transfer in existence on January 1, 1970, whether or not such contract is binding on the parties at such time. The transitional rule is also to apply only where a professional practice is involved. However, where a professional practice is involved and there is a related business which is transferred at the same time as part of the same agreement, such a transfer will be covered by the transitional rule.

This transitional rule is further limited by the requirement that the transfer must be made to a person who, immediately before the transfer, is an employee or partner of the transferor. Generally, this requirement is designed to limit the transitional rule to situations where the transferor and the transferee have had an ongoing relationship prior to January 1, 1970, and such ongoing relationship had, in part, been carried on in the assumption that the transferee was to be able to acquire the business over a period of time or at some time in the future.

The amendment to the partnership provisions (sec. 751(c)) is to apply to transactions occurring after December 31, 1976, in taxable years ending after that date. The transitional rules for section 1253 are to apply to transfers made after December 31, 1969, subject to the conditions specified above.

The Texas State Optical Company and perhaps others would be beneficiaries of this provision.

33. Clarification of an Employer's Duty to Keep Records and to Report Tips (sec. 1312 of the bill)

Present law

There has been some dispute regarding an employer's duty to report to the Internal Revenue Service charge account tips received by his employee (for example, a waiter or waitress) but not included in the monthly total tip amount usually reported by the employee to the employer. However, under Revenue Ruling 76-231, released May 26, 1976, the Service announced that employers are to be required to report such charge account tips.

Present law (sec. 6053(a) of the code) requires employees to report all tips received (including charge account tips) to their employers, usually on a monthly basis. The tips required to be reported to employers are tips received and retained after any tip-splitting (such as by waiters and waitresses with busboys) or tip-pooling (such as by a waiter with other waiters). Section 6051(a) requires employers to report on IRS Forms (W-2) as wages subject to income tax withholding and Federal Insurance Contributions Act (FICA) withholding only the tips actually reported to them by their employees pursuant to section 6053(a).

Section 6041(a) requires every employer of an employee earning $600 or more yearly to report the total of that employee's earnings to the IRS. As a result, the regulations (sec. 1.6041-2(a)(1)) specify that earnings in addition to those required to be reported as subject to withholding are required to be reported separately to the IRS on the Form W-2 for the employee. As stated above, Revenue Ruling 76-231 has recently held that this means that charge account tips not reported to the employer by the employee must nevertheless be reported to the IRS by the employer. If, because of tip-splitting or tip pooling, the amount reported by the employee on his income tax return differs from the total amount of tips reported by the employer for that employee, the employee is required by the ruling to attach an explanation of the difference to his income tax return.

Issue

Whether employers should be required to use their records to report to the Internal Revenue Service charge account tips which are not reported to the employers by their employees.

Explanation of provision

This provision was presented by Senator Fannin. It specifies that the only employer tips which an employer must report are the tips reported to the employer by the employee under present law (sec. 6053(a)). Accordingly, employers would not be required by law to keep accounts of employees' charge ticket tips or to report those tips to the IRS even if some of those tips are not reported to the employer by the employee. This clarification is accomplished through an amendment to section 6051(d) of the Code.

The provision also clarifies the employer's record-keeping requirements. Section 6001 is amended to provide that the only records an employer must keep in connection with charge tips are charge receipts

and copies of tip reporting statements furnished to employers by employees pursuant to section 6053(a). Thus, employers would not be required to maintain running tabulations of the allocation of total charge account tips to particular employees.

This provision applies to all restaurant employees and is also a matter of concern to both owners of restaurants and to those who issue credit cards.

34. Qualification of Fishing Organizations as Tax-Exempt Agricultural Organizations (sec. 1314 of the bill)

Present law

Agricultural organizations are exempt from tax under section 501 (c) (5) of the Code. Organizations devoted to promoting or improving fishing or such related occupations as taking lobster or shrimp are not treated as agricultural organizations by the Internal Revenue Service. However, organizations devoted to promoting or improving fishing and related pursuits may qualify for tax exemption under section 501 (c) (6) as business leagues.

Issue

Whether organizations or leagues devoted to fishing and related pursuits should be exempted from Federal income taxation as agricultural organizations in the sense of section 501(c) (5) of the code.

Explanation of provision

This provision was presented by Senator Hathaway. It clarifies the meaning of "agricultural" in section 501(c) (5) and provides that "agricultural" includes (but is not necessarily limited to) the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.

The term "harvesting * * * aquatic resources" includes fishing and related pursuits (such as the taking of lobsters and shrimp). Both fresh water and salt water occupations are to qualify as "agricultural" under the new definition. In addition, the cultivation of underwater vegetation, such as edible sea plants, qualifies as agricultural in nature, as does the cultivation or growth of any edible organism. Also, the operation of "fish farms" is to be considered agriculture under the new definition. However, aquatic resources are only to include animal or vegetable life, not mineral resources.

This provision is sought by fishing organizations in order to obtain the lower postal rates which exempt agricultural organizations receive.

35. Limitation on Percentage Depletion for Oil and Gas Wells (sec. 1317 of the bill)

Present law

Prior to the Tax Reduction Act of 1975 any taxpayer was entitled to a deduction for the greater of the percentage depletion allowance on gross income from an oil and gas property or the cost depletion allowance. The percentage depletion allowance was equal to 22 percent of such gross income, but not more than 50 percent of the taxable income from such property.

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for oil and gas with certain exceptions. Under the principle exception (the "small producer exemption"), percentage depletion is

allowed for a limited amount of production from wells located within the United States. The amount of production eligible for percentage depletion is an average of 2000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter. The percentage depletion rate for eligible production remains at 22 percent through 1980 and then is gradually reduced annually to 15 percent for 1984 and years thereafter.

For any taxpayer eligible for the small producer exemption, the deduction for any year attributable to such small producer exemption may not exceed 65 percent of the taxpayer's taxable income. However, if a taxpayer acquired an interest in an oil and gas property after 1974 and the property is "proven" at the time of transfer, the taxpayer is generally not allowed percentage depletion on production from that property under the small producer exemption. Also, a taxpayer is not eligible for the small producer exemption on any oil or gas production during any period for which such taxpayer is classified as a "retailer" of oil or gas, or products derived from oil or gas. Finally, a taxpayer is ineligible for the small producer exemption for any taxable year for which the taxpayer (or a related person) engages in refining of crude oil if, on any day during the year, he has refinery runs exceeding 50,000 barrels.

Issues

The changes in depletion rules made by the Tax Reduction Act of 1975 created certain possible problems involving the definition of retailers, the application of these rules to trusts, and certain other technical respects.

Three problems have arisen with respect to the retailers exclusion. First, present law could be interpreted to require that any person who sells any petroleum product (for example, selling household lubricating oil in a corner hardware) would be classified as a retailer of petroleum products and thus precluded from obtaining any percentage depletion. In addition, the definition of retailer could be interpreted to include direct sales by natural gas producers to utilities or industrial users. These sales, which in at least some cases are being encouraged by the Federal Power Commission, would be hampered by the impact of the loss of percentage depletion if they were considered to be retail sales. Third, the retailers exclusion as presently drafted can deny percentage depletion to a U.S. oil producer who happens to have retail outlets in foreign countries, even though those retail outlets in no way utilize the production of the taxpayer (or of any other U.S. producer).

In applying the new depletion rules to trusts, present law can operate to deny percentage depletion to either the trust or the beneficiary because of a mechanical defect in the method by which the 65 percent of taxable income limitation is applied to trusts. Further, a problem arises in applying the transfer rules to trusts in that the addition or deletion of a beneficiary can be treated as a transfer (and thus can result in the loss of percentage depletion) even though the change in beneficiaries results from birth, death, or adoption of members of the same family.

Finally, the Treasury Department has brought to the attention of the committee certain technical problems in the new depletion rules which the committee agreed could best be corrected by legislation.

Explanation of provisions

This provision was presented by Senator Dole. The provision makes three changes in the retailer exclusion. If, in the case of any taxpayer, gross receipts from the sale of oil or gas, or products derived therefrom, by all retail outlets of the taxpayer (and related persons) do not exceed $5 million for the taxable year, such taxpayer will not be treated as a retailer for that year. In addition, the retailers exemption is not to apply to direct bulk sales or natural gas to industrial users or utilities. Also, a taxpayer will not be subject to the retailer exclusion for any taxable year for which all retail sales of oil, gas, or their derivative products by retail outlets are made outside the United States, provided that no domestic production of the taxpayer or a related person is exported during the year in question or in the immediately preceding taxable year.

The provisions add an exception to the transfer rule so that a change of beneficiaries of a trust is not considered a "transfer" if the change occurs solely by reason of the death, birth, or adoption of any beneficiary in cases where the transferee was a beneficiary under the trust prior to the triggering event or is a lineal descendant of the grantor or any other beneficiary.

Under present law, in cases where income distributions are made to beneficiaries, such distributions reduce the taxable income of the trust and, because of the 65-percent of taxable income limitation, reduce or eliminate the deduction under the small producer exemption. Since beneficiaries to whom some depletion deduction is allocated can only receive the deduction to the extent it is first obtainable at the trust level this rule can result in no percentage depletion deduction for either the trust or any beneficiary. To correct this situation, the provision adds that, for purposes of the 65-percent-of-taxable-income limitation, a trust's taxable income shall be computed without a deduction for distributions to beneficiaries during the taxable year.

The provision also adds technical amendments suggested by Treasury. These amendments disregard any tentative percentage depletion deduction itself in computing the 65 percent of net income limitation, clarify the participation rules for apportioning basis in an oil and gas property among the partners, and tighten the rules defining related persons and entities for purposes of the retailers' and refiners' exclusions from the small producers exemption.

These provisions are effective for taxable years beginning after December 31, 1974 (the effective date of the provisions relating to the percentage depletion deduction in the Tax Reduction Act of 1975).

The $5 million de minimis rule will be of benefit to many producers who have small retail outlets. The provision relating to retail outlets outside the U.S. will be of benefit to Belco Petroleum Corporation. The trust provisions will be of benefit to trusts holding oil properties which do not use cost depletion.

Revenue effect

The provisions will reduce budget receipts by $18 million in fiscal year 1977, $10 million in fiscal year 1978, and $10 million in fiscal year 1981. All but a negligible amount of this revenue loss is attributable to the changes proposed in the retailer exclusions.

36. Simultaneous Liquidation of Parent and Subsidiary Corporations (sec. 1320 of the bill)

Present law

Under present law, a corporation which adopts a plan of complete liquidation and, within 12 months thereafter, sells or exchanges some or all of its assets and liquidates completely generally does not recognize gain or loss from the sale or exchange (sec. 337). The receiving shareholders will ordinarily be taxable on the sale proceeds (sec. 331).

This corporate nonrecognition rule does not apply, however, if the corporation making the sale or exchange is an 80 percent or greater controlled subsidiary of a parent corporation and if the parent takes a carryover basis in the assets of the subsidiary when it liquidates the subsidiary (sec. 337(c)(2)). If a corporate shareholder of a company which sells its assets is not taxable when it liquidates the subsidiary (as occurs under sec. 332), and if the subsidiary were not taxable on a gain from selling its assets, no tax at all would be paid on the gain represented by the sale proceeds.

In some situations, where both the parent and the subsidiary plan to liquidate after a sale of property by the subsidiray it is less important to tax the subsidiary on its gain from a sale of assets. In fact, a sale of assets by the subsidiary will be subject to tax under section 337(c)(2) and the shareholders of the parent corporation will also recognize gain when the parent liquidates. The Internal Revenue Service has held that this tax result can be avoided under present law if the parent first liquidates the subsidiary into itself (without recognizing gain or loss by reason of sec. 332) after which the parent adopts its own plan of liquidation (under sec. 337) and sells the assets formerly owned by the subsidiary. Under that sequence, neither the parent nor its subsidiary would recognize gain or loss and the parent's shareholders would recognize gain or loss on the liquidation of the parent.[1]

Issue

The issue is whether, consistent with the underlying purpose of section 337, the sequence of formal steps taken by the parties in this type of situation should determine what tax results occur.

Explanation of provision

This provision was suggested by Senator Hansen. The provision permits the general nonrecognition rule of section 337(a) to apply to a controlled subsidiary which sells property and then liquidates completely, provided that the parent corporation also liquidates completely in the same transaction. In order to obtain non-recognition of gain or loss, all other generally applicable requirements of section 337 would have to be satisfied (such as the rule that the sale of exchange of property must occur within 12 months after the subsidiary adopts a plan of complete liquidation).

The amendment requires, however, that in this situation not only must the selling subsidiary make a liquidating distribution of all of its remaining assets (less assets retained to meet claims) within 12 months after its plan of liquidation is adopted, but, in addition, during the same 12 month period, the parent corporation must also distribute all of its assets in its own complete liquidation.

[1] See Rev. Rul. 69-172, 1969-1 Cum. Bull. 99.

If the selling subsidiary is a member of a group of controlled subsidiaries having a common parent corporation, the amendment requires in effect that all other subsidiaries in the direct line of stock ownership above the level of the selling subsidiary must also liquidate completely.

This provision is effective for sales or exchanges made pursuant to a plan of liquidation adopted on or after January 1, 1976.

This provision has been recommended by the American Bar Association. It is believed to have general application.

37. Prohibition of State-Local Taxation of Vessels Using Inland Waterways (sec. 1321 of the bill)

Present law

Although Congress has the power to regulate interstate commerce, few Federal limitations upon the power of States to tax transactions in interstate commerce have been enacted. Public Law 86–272 [1], however, placed certain minimum standards upon the power of States to tax nondomiciliaries selling in the taxing State.

Congress has also done little to limit the power of States to tax common carriers in interstate commerce. However, Public Law 94–210,[2] the Railroad Revitalization and Regulatory Reform Act of 1976, does prevent States from taxing railroads at rates higher than those placed on other commercial property. Congress has not limited the power of States to tax vessels using navigable waterways.

Issue

The issue is whether a State or a political subdivision of a State having no "nexus" with a barge engaged in interstate commerce on navigable waters should be allowed to tax that barge.

Explanation of provision

This provision was included by the Committee at the suggestion of Senator Eastland. The provision prohibits any State or political subdivision of a State from taxing any vessel (or barge or other craft) using the navigable waters of the United States in interstate commerce. For the purposes of this limitation, it is understood that the term "interstate commerce" is to include not only the actual carrying of passengers or goods for hire, but also is to encompass return trips to the home port when the vessel may be carrying no passengers or cargo, trips to a port to bring on passengers or cargo, trips for the purpose of repair, and such other uses of navigable waters which case law or statutory law has deemed to be included in the term "interstate commerce."

This provision is not intended to limit the traditional taxing jurisdictions specifically recognized in the amendment. Therefore, this prohibition of local or State taxation is not to apply to any State or political subdivision of a State in which the craft is incorporated. The prohibition does not apply to taxation of any craft owned by an individual, partnership, or corporation which is domiciled in, or is a resident of, the State imposing the tax, or the State in which the political subdivision imposing the tax is situated. Finally, the provision does not apply to any tax of a State or political subdivision of a State in

[1] 86th Cong., 1st Sess., 73 Stat. 555 (1959).
[2] 94th Cong., 2d Sess., 90 Stat. 31 (1976).

which the craft has its home port. ("Home port" is to refer to the principal place of business use of the craft.)

This provision will benefit barge operators on the Mississippi River. It will also benefit those on other rivers as well.

38. Contributions to Capital of Regulated Public Utilities in Aid of Construction (sec. 1322 of the bill)

Present law

Under present law, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation take a zero basis in the hands of the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received or of certain other property is reduced by the amount of such contribution (sec. 362 (c)).

Certain regulated public utilities (water and sewage disposal) have traditionally obtained a substantial portion of their capital needed for the construction of facilities through contributions in aid of construction. The concept of contributions in aid of construction originates from a line of early Board of Tax Appeals decisions dealing with amounts contributed by customers to public utilities to pay for extensions of service lines necessary to enable them to be serviced by the public utility. The decisions treated such amounts as not giving rise to taxable income to the public utilities.

In 1975, the Service issued Revenue Ruling 75-557, 1975-2 C.B. 33, which withdrew the IRS's acquiescence in the early line of cases and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service are includible in the utility's income. The current ruling is made prospective for transactions entered into on or after February 1, 1976.

Issue

The issue is whether contributions in aid of construction to a water or sewage disposal utility should be treated as contributions to capital or as payments received for services rendered.

Explanation of provision

This provision was suggested by Senator Gravel. It amends the current rules concerning nonshareholder contributions to capital by specifying that amounts received as contributions in aid of construction by a water or sewage disposal utility (described in section 7701 (a)(33)(A)(i)) which are used for qualified expenditures and which are not included in the rate base for rate making purposes by the regulatory body having rate-making jurisdiction will be treated as nontaxable contributions to the capital of the utility.

For this purpose, the Secretary is to prescribe rules defining what items and amounts constitute a contribution in aid of construction. The following are examples of facilities which the committee considers to be contributions in aid of construction:

(1) A builder or developer constructs water lines and/or support facilities such as water filtration plants, water towers, etc., and turns such facilities over to a regulated water or sewage disposal utility.

(2) A builder or developer furnishes the necessary funds to a regulated water or sewage disposal utility which uses those funds to build certain water or sewage disposal facilities.

(3) A builder or developer pays for the water or sewage disposal facility (commonly referred to as an "advance") in return for the qualifying utility agreeing to pay the developer a percentage of the receipts from the facilities over a fixed period. Where the total payments made to the developer are less than the cost of the facilities which are transferred to the utility, any difference is to be treated as a contribution in aid of construction.

(4) A customer pays a fee to reimburse the utility for lines, valves, pipes, or meters, or a customer constructs his own lines which are turned over to the water or sewage disposal utility.

(5) Governmental units furnish regulated water or sewage disposal utilities with relocation fee payments where the local jurisdiction requires that certain construction be done by the utility in order to achieve a desired purpose of the government unit, *e.g.*, tearing up an old road to be replaced by a new one may require replacement of certain underground pipes and lines, providing additional sewage disposal facilities as a result of drainage projects, etc.

A qualified expenditure is an amount which is expended for the acquisition or construction of tangible capital assets,[1] where the acquisition or construction of the facility was the purpose motivating the contribution (*i.e.*, the purpose for which such amounts were collected).

This provision will be of general benefit to sewer and water companies.

Revenue effect

This provision will reduce budget receipts by $13 million in fiscal year 1977, $11 million in fiscal year 1978, and $11 million in fiscal year 1981.

39. Prohibition of Discriminatory State Taxes on Generation of Electricity (sec. 1323 of the bill)

Present law

Federal statutes provide few limitations on the power of States to tax nondomiciliaries or to impose special taxes on goods or services produced in the taxing State for nondomiciliary use outside the taxing State.

However, Public Law 86–272 [2] does establish certain minimum standards upon the power of a State to tax nondomiciliaries selling in the taxing State in interstate commerce. That Act did not affect the powers of States to tax goods or services produced within its boundaries for consumption outside its boundaries. Title II of the Act, however, also provided for further "studies of all matters pertaining to the taxation of interstate commerce...."

Issue

Whether Congress should exercise its constitutional power to regulate interstate commerce by forbidding States to place discriminatory

[1] For this purpose, a capital asset includes all expenditures which must be capitalized for such facilities under the normal rules of tax accounting (sec. 263).
[2] 86th Cong., 1st Sess., 73 Stat. 555 (1959).

taxes upon the generation or transmission of electricity within the taxing State for consumption outside its boundaries.

Explanation of provision

This provision was suggested by Senator Fannin. The provision prohibits any State, or political subdivision of a State, from imposing a tax on or with respect to the generation or transmission of electricity in interstate commerce if the tax is discriminatory against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. A tax is considered discriminatory if it directly or indirectly results a greater tax burden on electricity generated and transmitted in interstate commerce than on electricity which is generated and transmitted in intrastate commerce.

This provision is not intended to prohibit, restrain, or burden any other State which currently imposes a nondiscriminatory tax on the generation or transmission of electricity.

This provision replaces the current Title II of Public Law 86-272, which is the title calling for further congressional studies. A number of studies of the problem of multistate taxation of interstate commerce have already been made by congressional committees, and the present Title II is not required to authorize any additional studies that may be needed.

This provision will be of benefit to Arizona residents whose electricity is generated in New Mexico. It may have application elsewhere.

40. Tax-Exempt Annuity Contracts in Closed-End Mutual Funds (sec. 1505 of the bill)

Present law

Under present law, amounts contributed by certain tax-exempt employers for the purchase of an annuity contract (a tax-sheltered annuity) for an employee are (within limits) excluded from the gross income of the employee (sec. 403(b)). The tax-exempt employers to which this provision relates for the most part are religious, charitable and educational organizations and educational institutions operated by a State or local government.

Under a provision added to the Code by the Employee Retirement Income Security Act of 1974 (ERISA), amounts contributed by an employer for the purchase of stock of a regulated investment company which issues redeemable shares (an open-end mutual fund) in order to provide a retirement benefit for an employee are treated as amounts paid for the purchase of a tax sheltered annuity (sec. 403 (b)(7). However, amounts contributed by an employer for the purchase of stock in a regulated investment company which does not issue redeemable shares (a closed-end investment company) do not qualify for treatment as amounts paid for the purchase of a tax sheltered annuity.

Issue

The issue is whether amounts contributed by an employer for the purchase of stock in a regulated investment company which does not issue redeemable shares (a closed-end investment company) should qualify for treatment as amounts paid for the purchase of tax-sheltered annuities under the same circumstances as amounts contributed for the purchase of shares of an open-end mutual fund.

Explanation of provision

This provision was sponsored by Senator Bentsen. The provision permits an investment in stock of a closed-end investment company to qualify for treatment as a tax-sheltered annuity by depleting the provision in present law that limits qualifying investments in regulated investment companies o investments in those which only issue redeemable stock.

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

This provision will be of general benefit to closed-end mutual funds.

41. Pension Fund Investments in Segregated Assets Accounts of Life Insurance Companies (sec. 1506 of the bill)

Present law

Under present law, a life insurance company may base its reserve for certain annuity contracts (e.g., variable annuity contracts) on a segregated asset account. Accordingly the amounts paid in or paid out under the contract vary with the performance of the assets held under the account. Under the Code, the income, expenses, gains, and losses with respect to assets held under a segregated asset account under a contract for a qualified pension plan are generally not considered income, etc. of the life insurance company.

Under present law, a segregated asset account may not be used by a life insurance company except as the basis for a contract which provides for the payment of annuities. The Internal Revenue Service has taken the position that a segregated asset account can be used as the basis for a reserve for a contract by a particular life insurance company only if that life insurance company provides annuities under the contract. Therefore, an employer who wishes to have its qualified pension fund invested in a segregated asset account held by a particular life insurance company but wishes to purchase annuities from another life insurance company (or to provide annuity benefits directly from an employee trust) is unable to do so without incurring the cost of compensating the holder of the account for annuity purchase rate guarantees that will not be utilized.

Issue

The issue is whether the law should be changed to permit segregated asset accounts to be used as reserves for contracts which do not provide for annuities.

Explanation of provision

This provision was included at the suggestion of Senator Bentsen. The provision clarifies present law by providing that a segregated asset account can be used as an investment medium for assets of a qualified pension, profit-sharing, or anuity plan even though the account is held as a reserve under a contract which does not require the holder of the account to provide for the payment of annuities. The provision also permits assets of a qualified plan to be held in a segregated account instead of a trust. The provision does not in any way modify the requirements of title I of the Employee Retirement Income Security Act which requires certain pension plan assets to be held in a trust.

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

This provision will be of benefit to life insurance companies having annuity contracts (for example, variable annuities) handled on a segregated asset account basis.

42. Extension of Study of Salary Reduction and Cash or Deferred Profit-Sharing Plans (sec. 1507 of the bill)

Present law

Under present law, in general, an employee's contributions to a tax qualified retirement plan maintained by his employer are not tax deductible. In the case of a salary reduction plan, or a cash and deferred profit-sharing plan, however, the Internal Revenue Service has permitted employees to exclude from income certain amounts contributed by their employers to the plan, even where the source of these amounts is the employee's agreement to take salary or bonus reductions, or forego salary increases.

On December 6, 1972, the Service issued proposed regulations which would have changed this result in the case of salary reduction plans, and which called into question the continued viability of the treatment of cash and deferred profit-sharing plans.

In order to allow time for congressional study of these areas, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, contributions to plans in existence on June 27, 1974, are governed under the law as it was applied prior to January 1, 1972, and this treatment is to continue at least through December 31, 1976, or (if later) until regulations are issued in final form in this area, which would change the pre-1972 administration of the law. Section 2006 of ERISA provides that these regulations, if issued, are not to be retroactive for purposes of the social security taxes or the Federal withholding taxes, and are not to be retroactive prior to January 1, 1977, for Federal income tax purposes.

In the case of plans not in existence on June 27, 1974, contributions made on a salary reduction basis, or made, at the employee's option, to a cash and deferred profit-sharing plan, are treated as employee contributions (until January 1, 1977, or until new regulations are prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law while Congress has not yet determined what the law should be in the future.

Also to be covered under these principles are so-called "cafeteria plans," under which the employees may have a choice between certain fringe benefits, some of which would constitute taxable income to the employee, whereas other forms of benefit might not. Thus, cafeteria plans in existence on June 27, 1974, also are governed under the pre-1972 law until at least January 1, 1977. However, in the case of new plans, the value of any benefits selected under a cafeteria plan are to be includable in income until at least January 1, 1977 (or, if later, until new regulations in this area have been promulgated). In general, the same rules to be applied in determining whether or not a salary reduction plan was in existence on June 27, 1974, are also to be applied to cafeteria plans. Of course, minor plan amendments (such as changing the plan to allow cash payments to cover cases of breakage, i.e., where two alternative benefits available under the cafeteria plan do not have exactly the same value) would not cause an existing plan to be classified as a new plan for purposes of these rules.

Issue

The issue is whether the temporary freeze of the status quo provided for in section 2006 of ERISA should be extended beyond January 1, 1977, to allow additional time for Congress to study the questions involved in order to enact permanent legislation regarding salary reduction and cash and deferred profit-sharing plans.

Explanation of provision

This provision was suggested by Senator Brock. In order to allow additional time for congressional study of these areas, the provision extends the temporary freeze from January 1, 1977, until January 1, 1979.

This provision will be of benefit to Eastman Kodak Company. Irving Trust Bank, Xerox, TRW, and others.

43. Consolidated Returns for Life and Mutual Insurance Companies (sec. 1508 of the bill)

Present law

Under present law, life insurance companies, both stock and mutual, (taxed under section 802 of the code and hereafter referred to as life companies) are barred from filing consolidated income tax returns with corporations that are not life companies. A similar restriction applies to mutual insurance companies other than life companies (taxed under section 821 of the code and hereafter referred to as "other mutual insurance companies). On the other hand, stock property-liability insurance companies (and certain other companies) taxed under section 831 of the code are generally permitted to file consolidated returns with other types of corporations.

Issue

The issue is whether stock and mutual life companies and other mutual insurors should be allowed to file consolidated returns with other corporations.

Explanation of provision

This provision was suggested by Senator Ribicoff. It permits consolidated returns to be filed by stock or mutual life insurance companies (or other mutual insurors) and nonlife companies, subject to the restrictions that (1) the life company's taxable income cannot be reduced by more than one-half as a result of the consolidation, and (2) no more than one-half of a nonlife company's losses can be applied against a life company's income in any year. Any nonlife company losses not absorbed in this manner will still be available as carryovers of the nonlife companies to subsequent years. The filing of a consolidated return by an affiliated group which includes a life company and a property-liability company will permit the tax savings from the property-liability company's losses to be taken into account sooner in computing its statutory surplus. This larger surplus should increase the capacity of these companies to write insurance.

The provision is effective for taxable years beginning after December 31, 1977. However, a transitional rule is provided to limit the use of carryovers of losses and credits for pre-1978 years. These carryovers are to be treated as if the committee amendment had not been made. This means that the ability to absorb these losses or credits is not to be changed as a result of the new election to include life or other mutual

insurance companies in a consolidated return with other companies. The same principles also apply with respect to losses and credits which may be carried back to pre-1978 years.

This provision will be of benefit to life insurance companies which own casualty companies that incur losses.

Revenue effect

It is estimated that this provision will result in a decrease in revenues of $25 million in the fiscal year 1978, $55 million in the fiscal year 1979, $49 million in the fiscal year 1980, and $40 million in the fiscal year 1981.

44. Modifications in Investment Credit for Railroads (sec. 1701 of the bill)

a. Percentage Limitation on Credit

Present law

The amount of investment tax credit which can be taken in any one year may not exceed the first $25,000 of tax liability plus 50 percent of the liability greater than $25,000. In the Tax Reduction Act of 1975, the 50-percent limit was increased temporarily for public utility property to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, 60 percent for 1980 and back to 50 percent for 1981 and later years.

Issue

The generally low profit rates of railroads in recent years mean that the 50-percent limit of tax liability cannot accommodate investment credits earned under substantially expanded investment programs initiated by railroads since 1973. Without an adjustment of the kind made available to public utility property, railroads would accumulate substantial carryforwards which might be lost in the future when the carryforward period for the credit terminates.

The issue is whether railroads are similar enough to public utilities to receive the same treatment with respect to the 50-percent limit.

Explanation of provision

This provision was sponsored by Senator Hartke. Under this provision, railroads would be allowed to apply investment credits against 100 percent of tax liability in 1977 and 1978, 90 percent in 1979, 80 percent in 1980, 70 percent in 1981, 60 percent in 1982, and 50 percent in 1983 and later years.

The provision applies for taxable years ending after December 31, 1976.

The provision would benefit all railroads which would be operating at a low (or zero) profit margin for the next few years. The Association of American Railroads expressed an interest in this provision.

Revenue effect

Budget receipts would be reduced by this provision by $29 million in fiscal year 1977, $66 million in 1978 and $41 million in 1981.

b. First-in-First Out Treatment of Investment Credit

Present law

Investment tax credits earned currently are applied to the current year's tax liability before any carryforwards may be used. Unused credits expire at the end of the carryforward period.

Issue

Railroad companies would lose between $50 million and $80 million from 1978 through 1982 in carryforwards of expiring unused investment credits that have been carryforwards from earlier taxable years. The 50-percent limit and low taxable income did not permit full use of the credits currently.

The issues are whether the sequence prescribed for using investment credits should be changed and whether the change should apply to only the railroads.

Explanation of provision

This provision was suggested by Senator Curtis. The provision would permit railroads to apply carryforwards of the investment credit earned in prior years to the current year's tax liability before applying investment credits earned in the current year.

The provision applies to computations in taxable years ending after December 31, 1976.

This provision would benefit railroads generally which have unused carryforwards in the years after 1976 and who make additional investments in those years. The Association of American Railroads expressed an interest in this provision.

Revenue effect

The revenue loss from this provision is estimated as negligible during fiscal years 1977, 1978 and 1981 because the investment credits are fully utilized.

15. Amortization of Railroad Assets (secs. 1701 and 1702 of the bill)

a. Amortization of grading and tunnel bores

Present law

Railroads may elect to amortize, on a straight-line basis over a 5-year period, railroad grading and tunnel bores placed in service after 1968.

Issue

Before 1969, tax law followed ICC practice of not permitting depreciation of tangible railroad property that has an indeterminate useful life. In 1969, Congress enacted the present law provision for such property placed in service prospectively. In recent years, several railroads have entered into litigation to establish useful lives for depreciation purposes. Fifty-year amortization has been established since 1969 as a means to permit the taxpayer to recoup the costs of these investments in relatively small annual changes.

The issue is whether 50-year, straight-line amortization should be extended to grading and tunnel bores placed in service before 1969.

Explanation of provision

This provision was included in the House-passed bill. Under the provision, a railroad would be allowed to elect to amortize railroad grading and tunnel bores that were placed in service before 1969 on a straightline basis over a 50-year period. Property valuations for acquisitions or construction since 1913 have been established by the ICC or a State regulatory commission, and where valuation disputes have not been resolved, the basis for determination of capital gain or loss for Federal tax purposes may be used as the basis for amortization.

The provision is to apply for taxable years beginning after December 31, 1974.

This provision would be of benefit generally to all railroads.

Revenue effect

Budget receipts would be decreased by this provision by $21 million in fiscal year 1977 and $18 million in each subsequent fiscal year.

b. Treatment of certain railroad ties

Present law

When new ties are laid, the costs for materials and labor are capitalized, and no depreciation is claimed on the original installation. On replacement of the original equipment with track or ties of a like kind or quality, for example, new wood ties for old wood ties, the replacement costs are deducted as current expense. When the replacement is a like kind but improved quality, it is treated as a betterment, under which the betterment cost is capitalized and the remainder is expensed. This would be the case of wood ties capable of carrying heavier loads. Retirement and substitution involves replacement with a different kind of tie, concrete, for example, and the costs of the new ties are capitalized and the old ones are deducted as current expense.

Issue

Two railroads have been replacing wood ties with concrete ties. Under the present regulations, the costs of the retired ties would be deducted from the capital account and deducted as a current expense. The costs of the new ties would then be added to the capital account. This is consistent with the retirement-substitution approach. The committee amendment provides a variation of the betterment approach under which the taxpayer may take a current deduction equal to the current market value of the kind of ties to be replaced, and the remainder would be capitalized. In the House bill, the entire cost of a different or improved type of railroad tie would be deducted currently.

In addition, section 1701(b) of the committee bill would permit a railroad to elect 10-year, straight-line amortization for costs in their track accounts (which include ties) that are capitalized under the retirement-replacement method.

The issue is whether the costs of concrete ties should be allowed as an item of current expense and fully deducted in the year they are incurred or whether concrete ties should be treated under the same regulations and code provisions as are all other railroad ties.

Explanation of provision

This provision is a modification which tightens up the House-passed bill. Under the provision expenditures for acquiring and installing nonwood railroad ties may be deducted as a current expense equal to the fair market value of replacement wood ties and the remaining cost is to be charged to the capital account.

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 1975.

This provision would benefit the Black Mesa and Lake Powell Railroad and the Florida East Coast Railway.

Revenue effect

Budget receipts would be reduced by less than $5 million a year by this provision.

c. Amortization of railroad track assets

Present law

When new rails and ties are laid, the costs of these and other materials in the track account and labor are capitalized, and no depreciation is claimed on the original installation. On replacement of the original replacement with track or ties of a like kind or quality, e.g., new wood ties for old wood ties, the replacement costs are deducted as current expense. When the replacement is a like kind but improved quality, it is treated as a b tterment, under which the betterment cost is capitalized and the remainder is expensed. This would be the case of rails or wood ties capable of carrying heavier loads. The replacement-retirement method of depreciation and other forms of depreciation are mutually exclusive. As a result, if a railroad uses retirement replacement method for track account replacements, it cannot depreciate the original capital costs without consent of the Commissioner of the Internal Revenue Service.

Issue

The condition of U.S. railroad track had been allowed to deteriorate seriously, and the expenses of restoring them to satisfactory operating conditions are substantial. In addition, old tracks are being replaced with equipment able to sustain heavier freight cars and loads. Current accounting methods require capitalization of the costs incurred but do not permit any depreciation of the costs. When the item is replaced, the initial costs are expensed currently, and the costs of the repalcement are added to the capital account. This system reflects a belief that useful lives of assets in the track accounts are too indeterminate to warrant depreciation over a finite period.

The issues are whether assets in the track accounts should be treated as though they had determinate useful lives and how long a period should be allowed for their depreciation.

Explanation of provision

The provision establishes straight-line, 10-year amortization of assets in the track accounts (numbers 8, 9, 10, 11 and 12 in the ICC Uniform System of Accounts for Railroads).

This provision would apply to track account assets placed in service in taxable years that begin after December 31, 1975.

The provision would apply generally to all railroads.

Revenue effect

Budget receipts would be reduced by $4 million in fiscal year 1977, $10 million in fiscal year 1978 and $28 million in fiscal year 1981.

46. Residential Insulation Credit (sec. 2001 of the bill)

Present law

Under present law, no special credit or deduction is allowed for expenditures for insulation (including installation of a clock thermostat) of a taxpayer's own residence.[1]

[1] However, if the expenditures are undertaken in connection with the sale of the residence, then it has been held that those expenditures might be deductible under section 212 of the Code as being incurred in connection with the production of income. Also, if the insulation is of such a magnitude as to be an improvement in the house, then the expenditures may constitute additions to the taxpayer's basis in the house.

Issue

Whether the refundable tax credit provided in the committee's bill for installation of insulation upon a residence should be extended to include expenditures for a clock thermostat.

Explanation of provision

This provision was originally agreed to by the Finance Committee in July, 1975, as part of its consideration of the energy bill (H.R. 6860). The provision allows a refundable tax credit for 30 percent of the first $750 (for a maximum credit of $225) spent on insulating a residence used by the taxpayer paying for the insulation. The credit is to be available only for installations of qualifying material and payments made before January 1, 1979, and it is also limited to installations in structures already in use or habitable as residences on May 25, 1976.

The "insulation" for which the credit is to be available is to be any insulation, storm (or thermal) window or door, or any other similar item specifically and primarily designed to reduce the heat gain or loss of a residence. In addition, the material, to qualify, must have an original use commencing with the taxpayer, a useful life of at least 3 years, and it must meet criteria and standards to be prescribed by administrative officials.

The provision specifically includes clock thermostats as "any other similar item."

The inclusion of clock thermostats as qualifying for the insulation credit was done at the suggestion of Senator Mondale. Under the House energy tax bill, H.R. 6860, the determination of whether clock thermostats would be eligible for the insulation credit was left to the administrative officials who were to prescribe the criteria and standards for energy-conserving equipment generally.

Including clock thermostats benefits companies which manufacture and sell these items, including Honeywell, Inc.

47. Residential Heat Pump Credit (sec. 2002 of the bill)

Present law

Under present law, no special tax credit or deduction is allowed for installing a heat pump in a residence.

Issues

The issues are whether a tax credit should be allowed for installation of heat pumps on residences, and, if so, for what period of time the credit should be allowed.

Explanation of provision

The provision establishes a refundable income tax credit for the installation of heat pumps in, on, or in connection with any residential use by the taxpayer. The amount of the credit for installation of a heat pump is 20 percent of the first $1,000 of qualified expenditures, plus 12½ percent of the next $6,400 (maximum credit of $1,000). To qualify, the expenses must be paid by the individual (or individuals) who is using the structure as a residence.

The credit is for both the expenditures for the equipment itself and the expenditures for its installation. Expenditures for presently existing structures, but not for houses built during the credit period, will qualify for the credit.

The credit may be claimed only for qualified payments during the year or other tax period for which the tax return is filed.[2]

The equipment for which the credit may be claimed is that necessary to permit a heat pump to function in a home. This would include any special ducting required. "Function" in this sense refers to the capacity of a heat pump to heat or cool a building, to provide hot water for it, or to perform any of the other uses normal to the heat pump under the circumstances.

It is usually necessary, at least at this stage of the heat pump industry's technical advancement, to use heating or cooling units employing conventional energy sources as "back-ups" to the heat pump for use or supplemental use during periods when the outdoor temperature falls below approximately 25 degrees Fahrenheit. However, the credit is not to be available for expenditures for these back-up units. If joint owners install a heat pump for their common residence, the credit is to be apportioned among those who paid for the installations in accordance with the proportion which each paid bears to the total payment during the calendar year.

The heat pump credit is a refundable credit. As a result, a taxpayer whose tax liability is less than the amount of the credit would receive a refund of the difference, while the amount of his credit that equals the amount of his tax liability would be available to eliminate that liability.

Neither the current House bill nor the House-passed energy tax bill provided a tax credit, or any tax incentive, for installation of a heat pump.

This provision will benefit generally manufacturers of heat pumps. General Electric and Westinghouse have been mentioned as manufacturers which were interested in this provision.

Revenue effect

It is estimated that the credit for heat pumps and their installation will reduce revenues by $3 million in fiscal 1977, $5 million in fiscal 1978, and $6 million in fiscal 1979.

48. Investment Credits Relating to Energy Conservation and Production (sec. 2003 of the bill)

a. Business insulation credit

Present law

Insulation of business property is included among structural components which are not eligible for the investment credit.

Issue

Properly insulated structures will reduce heat loss in winter and heat gain in summer and thereby contribute to greater energy conservation.

The issue is whether a temporary tax incentive in addition to higher fuel prices will stimulate enough additional insulation of business structures to produce significant increases in business property insulation.

Explanation of provision

This provision extends the 10 percent investment credit to the

[2] Pre-July 1, 1976, expenditures and installations are to be ignored in determining whether and to what extent the expenditures limit is reached under this provision.

payment or accrual of costs for insulating an existing business property after December 31, 1976, and before January 1, 1979.

This provision was originally agreed to by the Finance Committee in its consideration of H.R. 6860 and had been included in the House-passed version of that bill.

Revenue effect

It has been estimated that budget receipts would be decreased by $11 million in fiscal year 1977, $26 million in 1978 and $15 million in 1979.

b. Business solar and geothermal equipment credit

Present law

Solar or geothermal energy equipment does not usually qualify for the investment credit because this equipment is usually considered as a structural component of a building.

Issue

Solar or geothermal energy could be used as a substitute or supplement for energy produced with petroleum or natural gas, and to the extent they are used, reliance on scarce petroleum or natural gas would be reduced.

The issue is whether a temporary tax incentive is necessary to encourage a great enough interest in the use of these forms of energy to accelerate the rate of their commercial installation.

Explanation of provision

This provision was proposed by Senator Fannin and Senator Packwood.

The provision establishes a special investment credit of 20 percent through 1981 and 10 percent through 1986 for both solar and geothermal energy equipment. The credit is available for equipment which becomes a structural component of a building and for equipment installed for lodging property.

The special investment credit would be effective at the 20-percent rate only for property acquired, or the construction of which is commenced, after May 25, 1976, and before 1982, and it is effective at the 10-percent rate for property acquired, or the construction of which is commenced, after 1981 and before 1987.

The provision generally benefits purchasers and manufacturers of solar and geothermal equipment. Among those expressing an interest in this provision are Union Oil Company, San Diego Gas and Electric, Geothermal Resources International, Earth Power Corporation, Geothermal Kinetics, Inc., Geosystems, Inc., and Thermal Resources, Inc.

c. Waste conversion equipment

Present law

There are no tax provisions in present law that relate specifically to the categories of equipment that include waste conversion equipment.

Issues

The types of equipment whose purchase might be stimulated by this provision would use various forms of combustible waste as a source of heat and in electrical generating systems in combination with oil or other sources of fuel. In addition, equipment that can be used in recycling discarded materials, or in preparing materials for recycling also would be eligible for this special credit.

The issue is whether a special tax incentive is needed to stimulate the use of these types of equipment instead of relying on price-cost relationships and the ordinary investment credit to encourage this form of petroleum conservation.

Explanation of provision

The provision establishes a 12-percent investment for equipment acquired after December 31, 1976, and placed in service before January 1, 1982. This credit would revert to the statutory rate in effect in 1982. Waste conversion equipment is defined to include equipment to use waste as a fuel, process waste into a fuel, sort and prepare waste for recycling, and recycling equipment.

This provision (and most of the following provisions) were originally agreed to by the Finance Committee in its consideration of H.R. 6860. The provision at that time was suggested by the staff as a replacement for the House provision establishing five-year amortization for this type of equipment.

Revenue effect

Budget receipts would be reduced by this provision by $2 million in fiscal year 1977 and $5 million in fiscal years 1978 and 1981.

d. Organic fuel conversion equipment

Present law

There are no tax provisions that relate specifically to organic fuel conversion equipment.

Issues

The processes for converting organic materials into energy or methanol or other synthetic fuels are known and are technologically feasible.

The issue is whether a temporary, special tax incentive is an adequate and desirable stimulus to the commercial introduction and utilization of this equipment.

Explanation of provision

An investment credit of 12 percent would be provided for equipment acquired after December 31, 1976, and placed in service before January 1, 1982. After that date, the ordinary rules of the current investment credit would apply to this equipment. Organic fuel conversion equipment is defined to mean any depreciable machinery or equipment used in converting organic material (other than waste material) into energy or into methanol or any other synthetic fuel which can be substituted for, or blended with. any petroleum product for use as a fuel.

e. Railroad equipment

Present law

No special tax provision is applicable to expenditures for these kinds of railroad equipment. Railroad rolling stock was eligible for five-year amortization through December 31, 1975, when the provision expired; the investment credit was not available to equipment for which an election had been made for rapid amortization. Alternatively, the railroad could take the investment credit and use ADR guideline lives with accelerated depreciation. For communications systems, classification yard equipment and freight handling equipment, the taxpayer

also may take the investment credit and use ADR guideline lives with accelerated depreciation.

Issue

Railroads for a number of years have been trying to increase investments in rolling stock, i.e., freight cars and locomotives, to keep pace with the continuing growth in railroad traffic. In recent years, railroads have found it necessary to rebuild or relocate classification yards as well as to install new equipment in those yards and elsewhere on their systems, to modernize communications, signal and traffic control systems and to install freight handling equipment for trailers and containers.

The issue is whether a special tax incentive is desirable to assist the railroads in carrying out these investment programs.

Explanation of provision

A 12-percent investment credit would be made available for railroad rolling stock, communications, signal or traffic control equipment, classification yard equipment, and freight handling equipment for loading or unloading trailers and containers on and from railroad cars that have been placed in service after December 31, 1976, and before January 1, 1982.

Revenue effect

Budget receipts would be reduced by this provision by $2 million in fiscal year 1977 and $5 million in fiscal years 1978 and 1981.

f. Deep mining coal equipment

Present law

All coal mining equipment is eligible for the current investment tax credit under the ordinary rules pertaining to all investment.

Issue

Current national policy seeks to increase reliance on domestic coal resources as an alternative fuel for petroleum and natural gas. Coal may be used directly as a fuel, or it may be converted into a liquid or gaseous state which can be used directly as a substitute for certain kinds of petroleum and natural gas. These objectives require substantial increases in coal mining capacity which in turn demand substantial investment in equipment to open and operate deep mines where the major coal reserves are located.

The issue is whether an additional two percentage points on the investment tax credit, or an alternative tax incentive, for a temporary period is needed to accelerate the process of opening new mines and extending existing mines to new and deeper coal seams, thereby rapidly increasing current coal mining production levels.

Explanation of provision

The provision allows a 12-percent investment credit for deep mining coal equipment placed in service after December 31, 1976, and before January 1, 1987. This provision covers depreciable equipment needed to reach underground coal deposits in slope mines, shaft mines, or drift mines and to extract the coal and bring it to the surface. It applies to the machines and equipment used in the process of actual mining, including conveyor belts, loading machines, and cars used to bring coal

and miners out of the mine. The credit also applies to machinery and equipment used in newly opened mines, in new shafts or tunnels in existing mines and in reopened shafts or tunnels.

Revenue effect

Budget receipts would be reduced by this provision by $11 million in fiscal year 1977, $27 million in 1978 and $42 million in 1981.

g. Coal liquefaction and processing equipment

Present law

Coal liquefaction and processing equipment are eligible for the current investment tax credit under the ordinary rules pertaining to all investment.

Issue

Current national policy seeks to increase reliance on domestic coal resources as an alternative fuel for petroleum and natural gas. Coal may be used directly as a fuel, or it may be converted into a liquid or gaseous state which can be used directly as a substitute for certain kinds of petroleum and natural gas. Converting coal into alternative forms of fuel demands substantial investment in equipment to perform essentially new production processes.

The issue is whether an additional two percentage points on the investment tax credit, or an additional tax incentive, for a temporary period is needed to accelerate the beginning of the industrial production of liquefied or gasified coal products.

Explanation of provision

The provision permits a 12-percent investment credit for the capital cost of depreciable machinery or equipment used for processing coal into a liquid or gas. This provision covers the range of liquids and gases which can be derived from coal (as well as usable byproducts), including low-BTU gas, high-BTU gas, synthetic crude oils and chemical feedstocks. In addition to gasifiers, reactors, and other equipment directly involved in processing the coal, eligible machinery and equipment includes the facilities for coal preparation and crushing; for upgrading coal oil to synthetic crude oil; for recovering solvent and sulfur; for preparing and disposing of water; and for product storage. Equipment used to drill wells, or to fracture coal in a mine and to pipe process gas to the surface, as part of underground gasification, is also included. The credit is also to be available for equipment used in the solvent refining process to remove sulfur, ash or other pollutants in order to produce a clean solid fuel from coal. The provision also permits machinery and equipment used in demonstration and pilot plants and in other testing activities (as well as machinery and equipment used in commercial production) to receive the extra credit if the equipment is the type that, if used in a trade or business, would be depreciable.

The credit would be available for eligible property that is placed in service after December 31, 1976, and before January 1, 1987.

h. Coal slurry pipeline equipment

Present law

Coal slurry pipeline equipment is eligible for the current investment tax credit under the ordinary rules pertaining to all investment.

Issue

Current national policy seeks to increase reliance on domestic coal resources as an alternative fuel for petroleum and natural gas. Coal may be used directly as a fuel, or it may be converted into a liquid or gaseous state and used directly as a substitute for certain kinds of petroleum and natural gas. These objectives require substantial expansion in the resources available to transport coal from where it is mined to where it is to be consumed or converted into another form of fuel.

The issue is whether an additional two points for a temporary period on the investment tax credit, or an alternative tax incentive, will accelerate the rate of investment in coal slurry pipelines and speed up the availability of coal in areas distant from the mines.

Explanation of provision

The provision allows a 10-year, 12-percent investment credit for costs incurred in installing pipeline equipment to carry coal in a slurry. Under the amendment, the credit is confined to the central elements of the slurry system: the main pipeline itself, the high-pressure main pipeline pumps (including spare pumps) necessary to move the coal through the line, and control and communications equipment for operating the pumping stations. The amendment defines an eligible pipeline as depreciable tangible property which constitutes a coal slurry pipeline and related equipment for transporting coal from the mine or other gathering point over relatively long distances from the mine (or from a related preparation plant) to another geographical area where the customer is located or where barges, rail lines, or other facilities for further shipment of the coal are located.

This provision would apply to equipment placed in service after December 31, 1976, and before January 1, 1987.

Revenue effect

Budget receipts would be reduced by $7 million in fiscal year 1977, $17 million in 1978 and $28 million in 1981.

i. Shale oil conservation equipment

Present law

Shale oil conversion equipment is eligible for the current investment tax credit under the ordinary rules pertaining to all investment.

Issue

Shale oil is a fuel that can be substituted for petroleum, and current national policy is to encourage development of many viable alternatives to petroleum and natural gas. Shale rock has been known for decades to contain oil, and the basic method for extracting oil from the rock is known. What is not known, however, is whether any of the processes would be a profitable industrial venture.

The issue raised by this provision is whether a temporary increase of two percentage points in the investment tax credit, or another comparable tax incentive, can stimulate and accelerate financially viable production of shale oil.

Explanation of provision

The provision establishes a 12-percent investment credit for capital expenditures for machinery or equipment which is necessary to reach,

extract and convert shale rock into raw shale oil. The provision does not cover expenditures for refining crude shale oil after it has been extracted from the rock. It is intended to cover machinery and equipment used to obtain water needed for the extraction process, to dispose of spent shale after the oil has been extracted, to dispose of run-off waters from wastes produced in the extraction, and to remove impurities from oil and gas produced from the shale. This provision also permits depreciable machinery and equipment used in demonstration and pilot plants for shale oil extraction to receive the 12-percent credit.

This provision would apply to equipment placed in service after December 31, 1976, and before January 1, 1987.

Revenue effect

Budget receipts would be reduced under this provision by $4 million in fiscal year 1977, $13 million in 1978 and $20 million in 1981.

j. TVA Compensatory adjustments

Present law

TVA is a wholly owned government corporation that is not taxable. It is required to make annual payments to the Federal Government as a return on the appropriated Federal funds invested in power facilities.

Issue

TVA uses coal as a fuel, instead of oil, for its electric power generating facilities, and as many electric utility companies do, TVA owns its own coal mines, is extending them and is opening new mines. It needs transportation facilities, and it also must seek and develop alternative sources of fuel. In this respect, it is behaving in the same way that its competitor private electric utilities are acting.

The issues raised are whether TVA's annual return to the Federal Government of the investment of appropriated funds is to be treated as though it were a payment of corporation income taxes and whether that payment should be reduced by an investment credit for purchase of certain types of facilities.

Explanation of provision

This provision was suggested by Senator Brock. The provision would allow TVA to reduce its annual payment to the Federal Government by an amount equal to a 12-percent investment credit earned on investments in equipment for organic fuel conversion, coal processing, coal slurry pipelines and shale oil conversion. Unused credits would be carried forward to the next fiscal year.

The provision would apply to payments made on or after October 1, 1976.

49. Deductions for Production and Intangible Drilling Costs of Geothermal Resources (sec. 2004 of the bill) the bill)

Present law

Present law is unsettled as to whether a depletion deduction or the intangible drilling cost deduction is allowable for the production of geothermal steam and associated geothermal resources. These questions

were answered affirmatively for the taxpayers in the case of *Reich v. Commissioner*, 454 F.2d 1157, 29 A.F.T.R. 2d 72–512 (C.A. 9, 1972).[1] However, the Internal Revenue Service is apparently not following that decision in cases arising outside of the Ninth Circuit.

The Tax Reduction Act of 1975 (94th Congress), generally eliminated the depletion allowance for oil and gas, except for a continued allowance for small producers. However, the depletion allowance for geothermal resources was *not* to be affected by that Act. According to the Conference Report (H.R. Rep. No. 94–120, p. 67):

> For geothermal steam, present law is unaffected, so that if steam is ultimately held by the courts to be a gas entitled to a 22-percent rate of depletion, this treatment will be continued.

As a result, the 22-percent depletion deduction allowable to gas wells immediately prior to the 1975 Tax Reduction Act is still available for geothermal energy if courts should decide, as did the *Reich* court, that a geothermal well is a gas well, and that the other requirements for depletion are met.

Under current law it is also possible that to the extent the costs of geothermal energy development (including intangible drilling and development costs) result in new processes or technology, they would be considered as research and experimental expenditures subject to the election to be currently deductible or to be amortized over a 60-month period commencing when the taxpayer begins to receive benefits from the expenditure. The Internal Revenue Service has ruled in Revenue Ruling 74–67, 1974–1 C.B. 63, that certain costs of developing a method for hydraulic mining of hard minerals, including a portion of the costs of drilling wells, are deductible as research and experimental expenditures. However, under present law the costs of ascertaining the existence, location, extent, or quality of any deposit of oil, gas, or other mineral are not deductible as research and experimental expenditures.

Issue

The issue is whether the right to expense intangible drilling costs currently and the depletion deduction allowance (or, as in the committee bill, something very similar to it) should be extended to the production of geothermal steam and associated resources.

Explanation of provision

This provision was sponsored by Senator Fannin. The provision extends current expensing of intangible drilling costs and an additional deduction for 22 percent of the gross income from the property[2] to the production of geothermal steam and associated geothermal resources. This deduction is not to exceed 50 percent of the taxpayer's taxable income from the geothermal steam and associated geothermal

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[1] In the *Reich* case, the Tax Court had held that the production of geothermal steam from wells was a gas, and that the taxpayers were entitled to expense currently their intangible drilling costs (sec. 263(c)) of the code. The court held further that the plaintiffs were entitled to the section 27½ percent depletion allowance for their production because their production was steam not exceeding 300° fahrenheit, (2) the particular geothermal reservoir in question was recommercible (3) steam was a gas and (4) the exclusion from the right to depletion of "water" in section 613(b)(7) of the code does not exclude steam from the depletion allowance.

[2] "Property" is to have the meaning given it by section 614 of the code which provides that it means, in general, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

resources property for the taxable year, computed without regard to this 22 percent deduction. The normal depletion deduction (section 611), however, is not allowed if a deduction under this provision is allowable. Thus, there cannot be any double deduction in the nature of depletion allowances regardless of whether the Internal Revenue Service or the necessary courts should determine ultimately that geothermal production is entitled to the depletion allowance.

It is intended that the term "22 percent of the gross income" is intended to mean the fair market value of the geothermal steam and associated geothermal resources at the wellhead. Thus, the gross income for which the percentage deduction is granted is not to include expenses of selling the steam or other geothermal resource such as costs of bringing the steam to the consumer.

The committee decided to provide a new deduction for this fledgling industry, rather than to clarify the existing sections of the code pertaining to depletion. This is done to avoid some of the technical questions which traditionally surround the depletion allowance. For example, this approach permits the steam or other geothermal resource to be entitled to the new deduction whether or not the steam or other geothermal resource from the property in question is exhaustible in nature.

The term "geothermal steam or associated geothermal resource" is the term used in the Geothermal Steam Act of 1970. In accordance with a number of the definitional provisions of that Act, the committee intends the term "associated geothermal resource" to include hot brine, dry heat (that may be produced with the use of such a substance as freon) and hot water (such as that which may be used directly to heat a building equipped with a heating unit employing hot water heating) and the other resources included in that Act. However, the tax benefits conferred by this amendment are not to extend to such minerals as are sometimes produced in the course of geothermal production, such as sodium, calcium, and trona. Furthermore, the term "geothermal steam and geothermal resources property" is to mean property from which the taxpayer extracts any product included in geothermal steam and associated geothermal resources, as defined by the Geothermal Steam Act of 1970.

The provision specifically requires that in order to be eligible for this deduction, the taxpayer must be the holder of an "economic interest" in the geothermal energy property. This is necessary to insure that the party who is taking the deduction did not acquire a mere economic advantage in the property in order to qualify for the deduction. The term "economic interest" as used in this amendment should be given the same meaning as the term has for purposes of computing depletion in the case of oil or gas wells.

Although the deduction provided for in this amendment is termed a "business deduction", it is to be allowable to the holders of passive interests in a geothermal energy property, such as holders of a landowner's retained royalty, an overriding royalty, or a net profits interest. It is not to be limited to holders of an operating interest, such as a working interest in the property.

The deductions of section 617 of the code for expenses paid or incurred for mining exploration before the beginning of the development stage of the mine are not to be allowed to geothermal production

which enjoys the benefits of the current expensing of intangible drilling costs and the 22-percent deduction provided by this provision.

The 22-percent deduction provided in the committee amendment is to constitute an item of tax preference (under section 57(a)(8) of the Code) for purposes of the minimum tax on tax preferences. Thus, the excess of the deduction over the adjusted basis of the property at the end of the taxable year (determined without regard to this deduction) is an item of tax preference.

In the case of leases, the new 22-percent deduction is to be apportioned between the lessor and the lessee. In the case of property owned for life by one person, with the remainder owned by another, the entire deduction is to be allowed to the life tenant. In the case of property held in trust, the deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the trust provisions, or, if there are none, on the basis of the trust income allocations. In the case of an estate, the deduction is to be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

The provision generally benefits purchasers and manufacturers of solar and geothermal equipment. Among those expressing an interest in this provision are Union Oil Company, San Diego Gas and Electric, Geothermal Resources International, Earth Power Corporation, Geothermal Kinetics, Inc., Geosystems, Inc., and Thermal Resources, Inc.

Revenue effect

It is estimated that current expensing of intangible drilling costs of geothermal properties and the deduction for 22 percent of gross income from geothermal properties will reduce receipts by $7 million for fiscal 1977, $15 million for fiscal 1978, and $21 million for fiscal 1981.

50. Recycling Tax Credit (sec. 2006 of the bill)

Present law

There is no provision in present law for a recycling tax credit or any other tax incentive to encourage salvage and reclaiming of materials as a means to conserve natural resources, reduce energy consumption, and reduce environmental litter. In section 611 and 613 of the Code, a schedule of percentage depletion rates is provided for various metals and minerals to encourage their discovery, development and mining so that the metals and minerals may be made available for industrial use. Percentage depletion also is provided to the owners of these materials because they are irreplaceable assets. Capital gains treatment is available on timber income and on royalties from coal and iron ore.

Issues

The issues are whether recyclers should be allowed a tax credit in order to give them tax incentives comparable to the treatment of virgin materials and, if so, whether the tax credit should be based on the increase in recycling over a base period.

Explanation of provision

This provision was sponsored by Senator Gravel. The provision establishes a tax credit to a recycler for purchases of recyclable solid waste materials that exceed 75 percent of the base period amount. A qualified recycling purchase is the amount paid by a recycler for recyclable solid waste material to be recycled in the United States for use in the United States.

The credit for ferrous and nonferrous metals could be one-half of the percentage depletion allowance provided for them, 10 percent for textile and paper waste, and 5 percent for glass and plastics. No credit is allowed by recycling gold, silver, platinum or other precious metals. The credit allowed for paper waste would be limited to a range of $5.50 and $8.00 per ton.

For recyclers in operation before 1973, the base period amount would be 75 percent of the average annual purchases for the calendar years 1973, 1974 and 1975 through December 31, 1980. After that date, the base period would be the 3 taxable years preceding each taxable year, and the base period amount then would become 75 percent of the average annual purchases during the 3-year periods.

For a new recycler after 1975, the base period amount in his first year of recycling production would be zero. For his second year of production, the base period amount would be 75 percent of the first year's purchases divided by 3. For the third year, the base period amount would be the purchases in the first 2 years divided by 3, and for his fourth year of production, he would have 3 years of prior activity to establish a base period.

The recycling credit is phased in during its first 3 years. The phasein provision limits the recycling credit in the first year to 25 percent and to 50 percent in the second year. The full amount of the credit earned by qualified purchases would be available for the third and subsequent years.

Recyclable solid waste materials are defined as materials which must have been used by an ultimate consumer and have no significant value or utility except as waste. Discarded containers from industrial plants are wastes that have been used by an ultimate consumer. Wastes that result from a fabrication process may be classified as postconsumer solid wastes, if they are not reusable by the fabricator in his process, and neither the fabricator nor a related person may be engaged in the manufacture that discards such wastes or in processing the waste material.

Recycling means a treatment which alters the composition or physical properties of a material and which transforms the material into a product or material which does not constitute recyclable solid waste. Recycling does not include a process consisting merely of sorting, shredding, stripping, compressing, and packiing for storage and shipment.

A purchase is not a qualifying purchase if the waste material is acquired from a relative, a corporate affiliate or subsidiary or in a tax-free exchange as under section 179(d)(2) of the Code.

Interest in this provision has been expressed by National Associates of Recycling Industries and the American Paper Institute.

Revenue effect

This provision will reduce budget receipts by $9 million in fiscal 1977, $39 million in fiscal 1978, and $345 million in fiscal 1981.

51. Repeal of Manufacturers Excise Tax on Buses and Bus Parts (sec. 2007 of the bill)

Present law

Under present law, a 10-percent manufacturers excise tax is imposed on the sale of buses having a gross vehicle weight of more than 10,000

pounds (sec. 4061(a)).[1] However, present law provides for an exemption from this tax for "local transit buses"; that is, those buses "which are to be used predominantly by the purchaser in mass transportation service in urban areas" (sec. 4063(a)(6)).[2] The tax also does not apply to school buses for "exclusive" use in transporting students and employees of schools operated by State or local governments or by nonprofit educational organizations (sec. 4221(e)(5)).[3]

In addition, there is an 8-percent manufacturers excise tax on parts and accessories (other than tires and inner tubes, which are taxed separately under sec. 4071) of the type used on buses (sec. 4061(b)).[4]

Issues

Bus transportation is a more energy-efficient mode of transportation than is automobile transportation, and there is no excise tax on the purchase of automobiles (since the repeal by the Revenue Act of 1971). One way to encourage the purchase of new private buses is to remove the 10-percent excise tax. In addition, there is the present tax distinction between exempt urban transit buses and taxable intercity buses. If the tax on buses is repealed, it is argued that the tax on bus parts should also be removed as there is no tax on automobile parts.

Explanation of provision

The provision repeals the 10-percent excise tax on all buses as well as the related 8-percent tax on bus parts and accessories. The House energy tax bill (H.R. 6860) provided for a repeal of the 10-percent excise tax on intercity-type buses only; that is, buses which would be used "predominantly by the purchaser in public passenger transportation service."

The repeal of the tax on buses and bus parts is effective for sales by the manufacturer, producer, or importer on or after the date of enactment. (The Committee Report incorrectly states that the provision is effective on or after July 1, 1976.) An article is not to be considered as sold before the date of enactment unless possession or right to possession passes to the purchaser before that time.

Revenue effect

It is estimated that this provision will reduce receipts by $19 million for fiscal year 1977, $20 million for fiscal year 1978, and $12 million for fiscal year 1981. (The fiscal 1981 figure is based upon the scheduled reduction in the 10-percent and 8-percent excise taxes described above to 5 percent as of October 1, 1979, the scheduled expiration date of the Highway Trust Fund under present law.) These revenues would otherwise go into the Highway Trust Fund (through September 30, 1979).

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[1] This tax is scheduled to drop to 5 percent on and after October 1, 1979.

[2] This exemption applies to privately-owned local transit buses, since "public" transit buses are exempted under the State-local government exemption provision (sec. 4221(a)(4)).

[3] This applies to persons purchasing school buses for contract operation to transport school students or employees, as school buses sold directly to State-local governments or to nonprofit educational organizations for their exclusive use are exempted already (sec. 4221(a)(4) and (5)).

[4] This tax is also scheduled to be reduced to 5 percent on October 1, 1979.

52. Exemption From the Retailers Excise Tax on Special Motor Fuels for Certain Nonhighway Use (sec. 2009 of the bill)

Present law

Present law imposes a retailers excise tax of 4 cents a gallon upon diesel fuel and certain other special motor fuels[1] where the fuel is sold or used for highway-related vehicle use. In the case of diesel fuel, no tax is imposed upon the use of diesel in a nonhighway motor vehicle nor in a motorboat, as the tax is imposed only if sold for or used by a "diesel-powered highway vehicle" (sec. 4041(a)). However, for the other special motor fuels, there is a tax of 2 cents a gallon for use by a nonhighway motor vehicle or motorboat (sec. 4041(b)).[2]

Issue

The issue is whether nondiesel special motor fuel should be treated the same as is diesel motor fuel when used for nonhighway purposes.

Explanation of provision

This provision was first considered by Finance Committee (and then adopted) during its consideration of H.R. 6860, the energy bill. The House energy bill repealed the tax only on buses operating within metropolitan areas.

The provision establishes an exemption from the 2 cents-a-gallon retailers excise tax on special motor fuels sold or used for a nonhighway motor vehicle (other than for motorboat or noncommercial aviation use). This will remove the tax distinction between, for example, liquefied petroleum gas (propane) used in an industrial lift truck (which is subject to a tax of 2 cents a gallon) and diesel fuel used in a diesel-powered lift truck (which is not subject to any fuel tax). The exemption is accomplished by providing for the refund or credit (under sec. 6427) for tax paid for such nonhighway use of special motor fuels.

This provision will benefit major bus lines, including Greyhound and Trailways.

This provision is effective for the use of certain special fuels for nonhighway motor vehicles as described above on or after July 1, 1976. Eaton Corporation and the National Liquified Petroleum Gas Association have expressed an interest in this provision. The provision will also benefit other companies.

Revenue effect

It is estimated that this amendment will involve a small revenue loss.

53. Oil Swaps (sec. 2010 of the bill)

Present law

Under present law, all petroleum and petroleum products imported into the United States are subject to import duties, which vary according to grade of petroleum or type of product.

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[1] The special motor fuels are benzol, benzene, naphtha, liquefied petroleum gas, casing head and natural gasoline or any other liquid (other than kerosene, gas oil, fuel oil, or any product taxable as gasoline under section 4081 or as diesel fuel under section 4041(a)). This tax is scheduled to be reduced to 1½ cents a gallon on October 1, 1979.

[2] This 2 cents-a-gallon reduction in the retailers excise tax on special motor fuel does not apply to such fuel for noncommercial aviation use, as there is a separate retailers tax of 7 cents a gallon through June 30, 1980 (sec. 4041(c)).

Canada has announced a policy of gradually reducing its crude oil exports to the United States to zero by the early 1980's, subject to annual reevaluation. United States refiners in several Northern Tier States including Michigan, Minnesota, Montana, North Dakota and Wisconsin, currently rely heavily on crude oil imported from the Northwestern Canadian Provinces.

Issue

The issue is whether it is necessary or appropriate to remove U.S. import duties from oil imported from Canada pursuant to swap arrangements in order to promote a joint U.S.-Canadian energy policy.

Explanation of provision

This provision was sponsored by Senator Mondale. The provision allows the duty-free treatment of oil imported from Canada under company-to-company oil swap arrangements made pursuant to agreement between the governments of the United States and Canada. The House bill contains no similar provision.

Under the provision, the United States tariff schedules are modified to exempt oil imported from Canada into the United States from the import duties set forth in Schedule 4, part 10 of these schedules, if the oil is imported as part of an oil swap arrangement. The types of petroleum eligible for such swaps are crude petroleum, including reconstituted crude petroleum, and crude shale oil. The quantity of imported Canadian oil exempted from U.S. duties must be equivalent in amount, kind, and quantity to the oil which is imported by Canada from United States refiners during the 30-day period preceding the date of entry of the Canadian oil into the United States.

The amount of Canadian oil entering the United States duty-free cannot be offset against any merchandise except the oil exported by United States refiners to Canada. In order for the Canadian oil to qualify for duty-free entry, the oil exported by United States refiners under the swaps must be either domestic United States oil or oil from foreign sources on which United States refiners have already paid the United States import duties.

The amendment provided by this provision has been requested by the Koch Refining Company, Wichita, Kansas, which operates a refinery in Pine Bend, Minnesota. However, the provision has general application to any U.S. refiner participating in U.S.-Canadian oil swaps.

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

This provision will benefit U.S. consumers who under the provision will be able to obtain Canadian oil at prices cheaper than the cost of transporting American oil to that part of the country.

Revenue effect

This provision is not expected to have any effect on tax receipts.

54. Modification of Transitional Rule for Sales of Leased Property by Private Foundations (sec. 2101 of the bill)

Present law

The Tax Reform Act of 1969 imposed taxes upon certain transactions between a private foundation and its "disqualified persons"

(generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions to which these taxes on "self-dealing" apply are the sale, exchange, or leasing of property (sec. 4941). In order to avoid unnecessary disruption of existing arrangements, however, the Act provided transitional rules permitting the continuation, without violation of the self-dealing rules, of any existing lease (in effect on October 9, 1969) between a foundation and a disqualified person until 1979, so long as the lease remains at least as favorable to the private foundation as it would have been under an arm's-length transaction between unrelated parties. However, for taxable years beginning after the end of 1979, the leasing arrangements must be terminated (sec. 101(l)(2)(C) of the 1969 Act).

Another transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person, if the sales price equals or exceeds the fair market value of the property being sold. However, this rule applies only to business holdings, and not to passive investments, including passive leases (sec. 101(l)(2)(B) of the Act).

In some instances a private foundation is leasing to a disqualified person property of a nature which is peculiarly suited to the use of that person. In these cases, it is argued that the value of the property to the disqualified person is greater than that to any other person. It is further argued that, since under present law such a leasing arrangement must be terminated not later than the end of the last taxable year beginning in 1979, and the property cannot be sold to the disqualified person by the private foundation, the foundation probably would be put in the position of being forced to dispose of its property to unrelated persons for less than the value of that property to disqualified persons.

This particular combination of circumstances regarding the sale of leased property was not brought to the attention of Congress when it was considering the Tax Reform Act of 1969. In effect, the sale-of-leased-property situation happens to fall between the above-noted existing transitional rules. Some feel that if this particular point had been presented in 1969, the Act would have been modified to deal with the situation.

Issue

The issue is whether an additional transitional rule should be provided under which a private foundation could sell, exchange, or otherwise dispose of (for fair market value) leased property to a disqualified person who is leasing such property, without the imposition of a self-dealing tax.

Explanation of provision

This provision was sponsored by Senator Mondale. The provision revises the transitional rules applicable to the private foundation provisions of the Tax Reform Act of 1969 by adding a new transitional rule to deal with the sale of property by a private foundation to a disqualified person. Under this rule, a private foundation could sell, exchange, or otherwise dispose of property (other than by lease) to a disqualified person if, at the time of the disposition, the foundation is leasing substantially all of that property under a lease subject to the

1979 lease transitional rule described above, and the foundation receives in return an amount which equals or exceeds the fair market value of the property. In computing the fair market value of the property, no diminution of that value is to result from the fact that the property is subject to any lease to disqualified persons.

The fair market value of the property is to be determined either at the time of its disposition, or at the time (after June 30, 1976) that a contract is executed for disposition of the property. The contractual valuation date permits the foundation and the purchaser to have a fixed price in their agreement even though some time may elapse and the value of the property changes between the contract and the actual settlement date.

This provision applies to dispositions occurring before January 1, 1978, and after the date of the bill's enactment, in taxable years ending after the date of the bill's enactment.

The Lund Charitable Foundation expressed an interest in this provision.

This provision originally was requested by the Charles W. Wright Foundation and Badger Meter, Inc. The provision is expected to have application to a number of other foundations and disqualified persons; however, its limitation to property subject to the 1969 Act transitional rule as to leases necessarily limits the number of cases that can arise under the provision.

55. Extension of Time To Conform Charitable Remainder Trusts for Estate Tax Purposes (sec. 2104 of the bill)

Present law

The Tax Reform Act of 1969 imposed new requirements which must be satisfied by a charitable remainder trust in order for an estate tax deduction to be allowed for the transfer of a remainder interest to charity. Under these new requirements, no estate tax deduction is allowable for a remainder interest in property (other than a remainder interest in a farm or personal residence) passing at the time of a decedent's death in trust unless the trust is in the form of a charitable remainder annuity trust or unitrust or pooled income fund. These rules generally apply in the case of decedents dying after December 31, 1969. However, certain exceptions were provided in the case of wills executed or property irrevocably transferred in trust on or before October 9, 1969. In general, these exceptions did not apply the new rules to these wills and trusts until October 9, 1972 (unless the will was modified in the meantime) to allow a reasonable period of time to take the new rules into account.

In 1970, the Internal Revenue Service issued proposed regulations with respect to the new requirements for a charitable remainder annuity trust or unitrust (under sec. 664 of the code). These regulations provided additional transitional rules allowing trusts created after July 31, 1969, (which did not come within the statutory exceptions) to qualify for an income, estate or gift tax deduction if the governing instrument was amended prior to January 1, 1971. Subsequently, the date by which the government instrument had to be amended was further extended by the Internal Revenue Service.[1] On

[1] T.I.R. 1060 (December 13, 1970) extended the date to June 30, 1971; T.I.R. 1085 (June 11, 1971), extended the date to December 31, 1971; T.I.R. 1120 (December 17, 1971); extended the date to June 30, 1972; and T.I.R. 1182 (June 29, 1972), extended the date to the 90th day after final regulations were issued.

August 22, 1972, the Internal Revenue Service issued final regulations which further extended the date to December 31, 1972. On September 5, 1972, the Internal Revenue Service published Rev. Rul. 72–395 which provided sample provisions for inclusion in the governing instrument of a charitable remainder trust that could be used to satisfy the requirements under section 664.

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

Where a judicial proceeding is required to amend the governing instrument, the judicial proceeding must begin before December 31, 1975, and the governing instrument must be amended to conform to these requirements by the 30th day after the judgment becomes final.

In any case, where the governing instrument is amended after the due date for filing the estate tax return, the deduction will be allowed upon the filing of a timely claim for credit or refund (sec. 6511) of an overpayment. However, no interest will be allowed for the period prior to the end of 180 days after the claim for credit or refund is filed.

Issue

The issue is whether to permit executors and trustees an additional period of time during which they can amend charitable remainder trusts to conform to the 1969 Act rules.

Explanation of provision

This provision was presented by Senator Curtis. The provision extends to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1969, must be amended in order to qualify as a charitable remainder annuity or unitrust or pooled income fund for purposes of the estate tax deduction. The provision also extends the date in the case of a trust created after July 31, 1969, pursuant to a will executed before December 31, 1977. Under the provision, if the governing instrument is amended by December 31, 1977, to conform to the requirements of a charitable remainder annuity or unitrust of pooled income fund, an estate tax deduction will be allowed for the charitable interest which passed in trust from the decedent even though a deduction originally was not allowed for this interest because the trust failed to qualify as a charitable remainder trust at the time of the decedent's death. This applies to trusts created after July 31, 1969, and before January 1, 1978. For these purposes, a trust which first became irrevocable, in whole or in part, after that date is treated as having been created after that date.

This amendment applies with respect to decedents dying after December 31, 1969.

This provision is generally applicable to trusts created after July 31, 1969 which are charitable remainder trusts.

Revenue effect

It is estimated that this provision will decrease budget receipts by $5 million during fiscal year 1977 and 1978.

56. Income From Fairs, Expositions, and Trade Shows (sec. 2106 of the bill)

Present law

Under present law, the unrelated business income tax applies to income from the conduct by an exempt organization of an unrelated trade or business. The term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income derived from such trade or business) to the exercise of its exempt purpose. The term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or services. The law further provides that, for the purpose of defining the trade or business activity, the activity is not to lose its identity as a trade or business merely because it is carried on within a larger aggregate or similar activities or within a large complex of other endeavors which may (or may not) be related to the exempt purposes of the organization.

One major purpose of this provision is to make certain that an exempt organization does not commercially exploit its exempt status for the purpose of unfairly competing with taxpaying organizations. An example of such activity specifically cited in the law is the carrying of advertising in a journal published by an exempt organization.

In one case (Rev. Rul. 68-505, 1968-2 C.B. 248), the Internal Revenue Service ruled that an exempt county fair association which conducts a horse racing meet with parimutuel betting is carrying on an unrelated trade or business subject to the unrelated business income tax. In another case, the Service has held, in a series of revenue rulings (TIR-1409, 1975-2 C.B. 220-226), that income that an exempt business league receives at its convention trade show from renting display space may constitute unrelated business taxable income if selling by the exhibitor is permitted or tolerated at the show.

Issue

The issue is whether these types of activities compete unfairly with taxpaying organizations such that the income from these activities should be subject to tax as unrelated business taxable income.

Explanation of provisions

This provision was sponsored by Senator Packwood (in the case of fairs and expositions) and by Senator Dole (for trade shows).

In the case of fairs and expositions, the provision applies to an organization which is exempt under section 501(c) (3), (4) or (5) of the Code (charitable, social welfare, or agricultural) and which operates a qualified public entertainment activity that meets one of the following conditions:

(1) the public entertainment activity is conducted in conjunction with a public international, national, State, regional, or local fair or exposition;

(2) the activity is conducted in accordance with State law which permits that activity to be conducted only by that type of exempt organization or by a governmental entity; or

(3) the activity is conducted in accordance with State law which allows that activity to be conducted for not more than 20 days in any year and which permits the organization to pay a lower percentage of the revenue from this activity than the State requires from other organizations.

In order to qualify for this treatment, the organization must regularly conduct, as one of its substantial exempt purposes, a fair or exposition which is both agricultural and educational. Thus, a book fair held by a university does not come within this provision since such a fair is not an agricultural fair or exposition.

In the case of conventions and trade shows, the provision applies to an organization which is exempt under section 501(c) (5) or (6) of the Code (generally, unions or trade associations) and which regularly conducts as one of its exempt purposes a convention or trade show activity which stimulates interest in, and demand for, an industry's products in general. In order to constitute a qualifying convention and trade show activity all the following conditions must be met:

First, it must be conducted in conjunction with an international, national, State, regional, or local convention or show;

Second, one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and,

Third, the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

The conducting of qualified public entertainment activities and qualified convention and trade show activities is not to subject the organization to the unrelated business income tax and the conducting of such activities is not to affect the tax-exempt status of the organization.

This provision applies to taxable years beginning after December 31, 1962, with respect to qualified public entertainment activities and to taxable years beginning after December 31, 1969, with respect to qualified convention and trade show activities.

The provision with respect to fairs has general applicability to a number of States. In addition the provision includes special rules to cover problems with respect to the laws in two States—Oregon and Nebraska. In the case of Oregon, since the State law only allows an exempt organization to have five days of racing a year, it is not profitable for them to build a separate race track. As a result, a commercial track is rented but in order not to compete with the fair itself, the period of time for racing is not conducted during the period the fair is being held. In the case of Nebraska, the State law does not permit horse racing by other than exempt organizations. Thus, there is no competition with any commercial activity and the amendment covers the exempt organizations in this case. The organizations expressing an interest in this provision are as follows: Pacific International Livestock Exposition in Oregon, AKSARBEN in Nebraska, the Maryland State Fair, and the Los Angeles County Fair.

The National Society of Association Executives expressed interest in the provision as it applies to trade shows.

57. Generation-Skipping Transfers (sec. 2202 of the bill)

Present law

Under present law, a Federal gift or estate tax is generally imposed upon the transfer of property by gift or by reason of death. However,

the termination of an interest of a beneficiary (who is not the grantor) in a trust, life estate, or similar arrangement is not a taxable event unless the beneficiary under the trust has a general power of appointment with respect to the trust property.

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

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

Issue

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

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

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

There are many legitimate nontax purposes for establishing trusts. However, many believe that the tax laws should be neutral and that there should be no tax advantage available in setting up trusts. Thus, the issue is whether property passing from one generation to successive generations in trust form should, for estate tax purposes, be treated substantially the same as property which is transferred outright from one generation to a successive generation.

Explanation of provision

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

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

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

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

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

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

Where generation-skipping transfers are made outside the family, generations would be measured from the grantor. Individuals not more

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

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

58. Gift Tax Treatment of Certain Annuities (sec. 2203 of the bill)

Present law

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

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

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

Issue

The issue is whether the gift tax provisions exempting interests in qualified plans should have uniform application in both common law and community property States regardless of which spouse dies first.

Explanation of provision

This provision was sponsored by Senator Packwood. The provision permits a gift tax exclusion for the value, to the extent attributable to employer contributions, or any interest of a spouse in specified employee contracts, or true or plan payments, where two conditions exist.

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

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

This provision would not, in the case of the nonemployee spouse in the community property State, provide any exclusion for a property interest in the plan to the extent it is attributable to the contributions of the employee spouse.

Thus, the nonemployee spouse's community interest in the plan which is attributable to contributions made by the employee spouse could be subject to the gift tax, as under present law.

The provision would apply to calendar quarters beginning after December 31, 1976.

The provision would benefit participants in qualified pension and profit-sharing plans who live in community property States.

59. Outdoor Advertising Displays (sec. 2301 of the bill)

Present law

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

In the case of outdoor advertising billboards and displays, there is some question whether this property qualifies as real property eligible for the special replacement rules of section 1033(g). The Internal Revenue Service has ruled that billboards are real property for purposes of the investment credit and depreciation recapture.[1] However, this administrative interpretation has been successfully challenged in several court cases which hold that billboards are tangible personal property (and not real property) for purposes of the investment credit.[2]

Issue

Federal and State highway beautification statutes authorize the Government to condemn and purchase privately-owned highway billboards. Because of continuing restrictions on where highway billboards may be located, the former owners of condemned billboards (particularly small companies) are prevented from using their condemnation awards to build and situate replacement billboards; these taxpayers have been forced instead to reinvest their awards in other types of real property. The present uncertainties in the property classification of billboards may prevent these reinvestments from qualifying for treatment as involuntary conversion replacement property even though the condemned billboards have consistently been treated by the owners as real property.

Explanation of provision

This provision was sponsored by Senator Ribicoff. It establishes an election for taxpayers to treat outdoor advertising displays as real property. This election, once made, is irrevocable without the permission of the Secretary and it applies to all qualifying outdoor advertising displays of the taxpayer. Outdoor advertising displays do not qualify for the election where the taxpayer has previously treated the property as tangible personal property by claiming either the investment credit or additional first-year depreciation.

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

The election under the provision may be made for purposes of classifying replacements of qualifying outdoor advertising displays in taxable years beginning after 1970.

This provision applies generally to companies which have had billboard property condemned under the Highway Beautification Act. Mr. Douglas Snarr has expressed an interest in this provision.

60. Interest on Certain Governmental Obligations for Hospital Construction (sec. 2308 of the bill)

Present law

In general, industrial development bonds are not eligible for exemption from the Federal income tax on interest income. The term indus-

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

[2] See, e.g., *Alabama Displays, Inc. et al. v. United States*, 507 F.2d 844 (Ct. Cl. 1974); *Whitco Industries, Inc. et al. v. Commissioner*, 65 T.C. — No. 59 (1975).

trial development bond includes obligations from which all or a major portion of the proceeds are used in a trade or business by a person other than an exempt person. An exempt person is defined as a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a), except for unrelated trade or business activity.

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

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

Issue

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

The issue is whether there should be an exemption from the limitation under present law to permit the issue of tax-exempt bonds for private hospitals.

Explanation of provision

This provision was sponsored by Senator Bentsen.

The provision adds a special exception from the $5 million limit for small issues which will permit issues up to $20 million for a private hospital which is certified as necessary by the appropriate State health agency.

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

Revenue effect

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

61. Group Legal Services Plans (sec. 2309 of the bill)

Present law

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

However, depending on the structure of the plan, it appears that the employee will be required to include in his income either (1) his

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

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

Issue

The issue is whether it is necessary or appropriate to provide a tax incentive to promote prepaid legal services plans.

Explanation of provision

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

In order to be a qualified plan under which employees are entitled to the tax-free benefits provided by the amendment, a group legal services plan must fulfill several requirements with regard to its provisions, the employer, and the covered employees. These requirements are designed to insure that the tax-free fringe benefits are provided on a nondiscriminatory basis with regard to contributions and benefits, as well as eligibility for enrollment, and to minimize the possibility of tax abuse through the misuse of such plans. Additional requirements include provisions for a written plan, notice to employees about benefits, contribution arrangements, IRS administration, the treatment of existing plans, and definitions and rules for partnerships and proprietorships, as well as corporations.

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

Legislation excluding employer contributions and benefits provided to employees under group legal services plans has been requested by the Laborers' International Union of North America, AFL–CIO, and the National Consumer Center for Legal Services, Washington, D.C. The American Bar Association has also urged the adoption of a tax incentive for group legal services plans.

Effective date

This provision applies to taxable years beginning after December 31, 1973. Existing plans are allowed a transition period, in some cases extending through 1981, to conform to the requirements contained in this provision.

Revenue estimate

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

62. Exchange Funds (sec. 2310 of the bill)

Present law

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

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

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

Issue

One tax issue raised by the appearance of exchange funds in partnership form is whether a tax-free diversification of stock investments should be permitted through use of the partnership form when the same result cannot be achieved, under present law, through a corporation or through a direct exchange of portfolio stocks for other similar stocks.

Another issue is whether the tax advantages of an exchange fund (namely, no tax to the investor on his appreciation at the time his stock is pooled with others and taxfree diversification of his invest-

ment assets) should be available through other forms, such as a trust, common trust fund, or a corporate reorganization.

Explanation of provisions

The House, on May 3, 1976, passed H.R. 11920 which deals with the tax treatment of partnership exchange funds and mergers of certain investment companies (generally mergers of personal holding companies with mutual funds), where a taxpayer's principal interest is to diversify his investments without current payment of any tax. In general, the House bill conforms the partnership tax rules to those for corporations in the case of exchange funds and, as a result, makes taxable the transfer of appreciated stocks or securities (as well as other property) to a partnership if, as a result, the transferor' investment interests are diversified.

Senator Bentsen sponsored the addition of the House-passed bill (H.R. 11920) to the Tax Reform Bill. Senator Talmadge sponsored the extension of the transitional rule in the House-passed bill from February 17, 1976, to March 26, 1976, the day before the House Committee on Ways and Means held hearings on the bill.

Partnership exchange funds

The committee amendment adopts the House-passed bill to treat the original exchange of appreciated stocks for shares of a swap fund as a taxable sale or exchange with other investors made through the fund. Thus, the committee amendment is essentially the same as the provisions of H.R. 11920, with certain modifications.

Family partnerships.—The provision adds an exception to the partnership rules of H.R. 11920, as passed by the House, for certain family partnerships. This was a suggestion made by the staff. Where stocks (or other property) are pooled within a single family group, the basic problems against which the partnership rules in the provision are directed give less reason for concern. The provision accordingly provides that property can continue to be transferred to a partnership tax free (in exchange for an interest in the partnership) if certain requirements are met. Thus, under this rule a family group may share the income from a pool of stocks so long as each contributing partner in effect bears the tax on the built-in gain which existed at the time he contributed that property to the folio.

Effective date.—The provisions for partnership exchange funds apply generally to transfers made to a partnership after February 17, 1976.

The House bill added "grandfather" rules for certain funds under which the general effective date would not apply to completed transfers of property to a partnership after February 17, 1976, if several conditions are satisfied. First, the partnership must have filed for (or received) a private ruling from the Internal Revenue Service on or before February 17, 1976, relating to its character as an exchange fund. Second, the partnership must have filed a registration statement (if required by the securities laws to do so) with the Securities and Exchange Commission on or before February 17, 1976.[1]

[1] This second requirement would not apply in the case of partnerships which plan to make a private offering within the meaning of the securities laws or which otherwise are not required to file a registration statement with the SEC.

The provision covers also several other exchange funds which had taken significant steps toward being formed before the February 17 date contained in the House bill, but, at that time, had not filed a tax ruling request or a registration statement with the Securities and Exchange Commission. The committee was informed that the reason was that there was a great deal of uncertainty over the status of the law, and informal contacts with Internal Revenue Service personnel indicated that the rulings would not be acted on until the Service's position in this area was clarified. As a result, these funds did not file their ruling requests or registration statements by February 17, 1976, although they had expended considerable sums of money and time in preparing for the organization of their fund, having been aware of the previous private ruling issued to the Vance Sanders Fund. The provision extends the date provided in the House bill until the time the House Committee on Ways and Means held hearings on its bill. Accordingly, the provision extends the cutoff date under the grandfather rules to March 26, 1976. In addition, in lieu of the dual conditions for grandfather treatment, the committee amendment imposes conditions in the alternative, so that a fund can qualify for grandfather treatment if it either filed a ruling request with the Service or a registration statement with the Securities and Exchange Commission before March 27, 1976.

The transitional provision provided in the House bill covers the following partnership exchange funds: Vance Sanders, State Street, Fidelity, American General, and Boston Company Exchange Associates. The extension of the transitional date from February 17, 1976, to March 26, 1976, covers the following additional exchange funds: Chestnut Street and Equity.

Trusts

In order to cover the possible use in the future of trusts as exchange funds, the provision also adds a specific rule to the Code that gain (but not loss) will be recognized to the transferor on a transfer of property to a trust in exchange for an interest in other trust property where the trust would be an "investment company" (within the meaning of sec. 351) if the trust were a corporation. This is the same as the House bill.

Common trust funds

To cover the possible use of a bank's common trust fund as an exchange fund, the amendment provides that the admission of a participant to a common trust fund is to be considered to be the purchase of, or an exchange for, the participating interest in the fund. As a result, gain or loss will be realized by the participant on any transfer of property to the common trust fund. This is the same as the House bill.

Mergers of two or more investment companies

The provision adds an exception to the definition of a taxfree "reorganization" in present law in order to require recognition of gain or loss on exchanges which, from an investor's standpoint, resemble the formation of an exchange fund. This exception is provided in specific terms in order not to change the application of the reorganization rules to transactions other than those which enable investors to obtain the primary advantages of an exchange fund. This is the same as the House bill.

Revenue effect

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

63. Special Credit for Wind-Related Energy Equipment (sec. 2505 of the bill)

Present law

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

However, a 10-percent investment credit is permitted for the capital costs of several types of business machinery, equipment, and facilities used in a trade or business or held for the production of income. As a facility used as an integral part of the production of electrical energy, wind-related energy equipment used to generate electricity may be entitled to the investment credit of present law (sec. 48(a)(1)(B)(i)), unless it is a structural component of a building.

Issue

The issue is whether a tax credit should be provided for the installation of wind-related energy equipment to provide energy for certain residential and commercial uses.

Explanation of provision

This provision was sponsored by Senator Hathaway.

The provision establishes a refundable income tax credit for wind-related energy equipment installed on or adjacent to a residence. Like the solar and geothermal equipment credits, the credit for wind-related energy equipment is 40 percent of the first $1,000 of qualified expenditures, plus 25 percent of the next $6,400 (a maximum credit of $2,000). To qualify, both the equipment and its installation must be paid for by the individual (or individuals) using the edifice as a residence. Thus, the owner or a tenant may qualify, but a builder or developer adding the wind-related equipment to a house he does not intend to use as his residence would not qualify for this credit (although he might qualify for the investment credit given under this amendment for wind-related energy equipment installed for commercial or industrial purposes).

This tax credit is to be allowed only for installations and expenditures made, or, in the case of an accrual basis taxpayer, incurred, through 1980. Before that time, the committee will review the credit to see whether it should be continued after 1980. Also, both the installation and the expenditure must occur after June 30, 1976. The credit is for both the expenditures for wind-related equipment itself and also for expenditures for its installation.

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

The wind-related energy equipment credit is a refundable credit. As a result, a taxpayer whose tax liability is less than the amount of the

credit would receive a refund of the difference, while the amount of his credit that equals the amount of his tax liability would be available to eliminate that liability.

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

This provision will benefit purchasers and manufacturers of windmills. Researchers at the University of Maine, among others, have expressed interest in it.

64. Income Earned Abroad by U.S. Citizens Living or Residing Abroad (sec. 2503 of the bill)

Present law and committee amendment

U.S. citizens who are working abroad may exclude (under section 911) income up to $20,000 of earned income for periods during which they are present in a foreign country for 17 out of 18 months, or during the period they are bona fide residents of foreign countries. In the case of individuals who have been bona fide residents of foreign countries for three years or more, the exclusion is increased to $25,000 of earned income.

The provision retains the exclusion for certain earned income of individuals abroad but makes three modifications in the computation of the exclusion. First, it provides, as did the House bill, that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that are excluded from gross income under the earned income exclusion. Thus, foreign income taxes that are paid on excluded amounts are not to be creditable or deductible.

Second, it provides that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded. For the purpose of determining the rate brackets applicable to the nonexcluded income, the taxpayer is entitled to subtract those deductions which would be otherwise disallowed by reason of being allocable to the excluded earned income.

Since earned income is now subject to an exclusion with the other income being taxed at the higher brackets; any foreign tax credits disallowed by reason of being allocable to the excluded earned income are to be considered as those taxes paid on the first $20,000 or $25,000 of excluded income. For this purpose, the same rate of progressiveness is to be assumed on the foreign taxes as is the case for the U.S. taxes.

Third, the amendment makes ineligible for the exclusion any income earned abroad which is received outside of the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country. The tax avoidance purpose does not have

to be the only purpose for receiving the money outside of the country in which earned, nor does it have to be the principal reason for receiving the money outside of that country.

Issue

Under the committee amendment, individuals who derive earned income in a foreign country which is taxed by that foreign country under a progressive rate system which is higher than the progressive rate system in the United States have excess foreign tax credits on their excluded earned income. These individuals are better off without the earned income exclusion, since they would then be able to use their excess credits against other foreign source income which they may derive. The issue is whether these individuals should be entitled to an election not to apply any earned income exclusion.

Explanation of provision

This provision was sponsored by Senator Fannin. The provision allows an individual to elect (in such manner and time as the Secretary of the Treasury prescribes) not to have the earned income exclusion apply. If an individual makes the election for a taxable year, the election is binding for all subsequent taxable years and may not be revoked except with the consent of the Secretary. This provision will benefit the Paris office of the law firm of Surrey, Karasik and Morse and members of the National Constructors Association.

65. Level Premium Annuity Contracts Held by H.R. 10 Plans (sec. 2508 of the bill)

Present law

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

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

Issue

The issue is whether the 25 percent rule should be modified to permit H.R. 10 plans to continue in their present form.

Explanation of provision

This provision was sponsored by Senator Bentsen.

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

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

66. Unrelated Business Income of Tax-Exempt Hospitals (sec. 2509 of the bill)

Present law

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

Issue

The issue is whether one tax-exempt hospital should be permitted to provide certain services to other tax-exempt hospitals without tax.

Explanation of provision

This provision was included at the suggestion of Senator Curtis.

The provision establishes that a hospital is not engaged in an unrelated trade or business simply because it provides services to other hospitals if those services could have been provided, on a tax-free basis, by a cooperative organization consisting of several tax-exempt hospitals. The exclusion from the unrelated business tax applies only where the services are provided only to other tax-exempt hospitals, each one of which has facilities to serve not more than 100 inpatients,

and (2) the services would be consistent with the recipient hospital's exempt purpose.

The provision will benefit hospitals generally which engage in cooperative efforts with other exempt hospitals.

Effective date

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

67. Hospital Laundry Facilities (sec. 2509 of the bill)

Present law

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

Issue

The issue is whether tax-exempt hospitals should be permitted to provide laundry and clinical services to themselves without tax through a cooperatively organized and operated service organization.

Explanation of provision

This provision was sponsored by Senator Ribicoff.

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

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

This provision was urged by the American Hospital Association.

68. Certain Charitable Contributions of Inventory (sec. 2511 of the bill)

Present law

Under present law (sec. 170(e)), a taxpayer who makes a charitable contribution of property must reduce the amount of the deduction (from fair market value) by the amount of ordinary gain he would have realized had the property been sold instead of donated to charity. (Under certain circumstances, a taxpayer may have to reduce the amount of his charitable contribution by a portion of the capital gain

he would have received if the property had been sold.) Thus, the donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) may deduct only his basis in the property rather than its full fair market value.

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

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

Issue

The issue is whether it is desirable to provide a greater tax incentive than in present law for contributions of certain types of ordinary income property which the donee charity uses in the performance of its exempt purposes so long as the donor could not be in a better after-tax situation by donating the property than by selling it.

Explanation of provision

This provision was included at the suggestion of Senator Ribicoff.

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

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

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

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

CARE and the American Council of Voluntary Agencies for Foreign Services, Inc., have expressed an interest in this provision.

Revenue estimate

It is estimated that this provision will result in a reduction in corporate tax liability of $16 million in fiscal year 1977, $22 million in fiscal year 1978, and $24 million in fiscal year 1981.

69. Tax Liens, Etc., Not to Constitute "Acquisition Indebtedness" (sec. 2513 of the bill)

Present law

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

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

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

Where property is acquired subject to a "mortgage or other similar lien," the debt secured by that lien is generally considered acquisition indebtedness. The Treasury Regulations (Regs. § 1.514(c)-1(b)(2)) provide, in effect, a special rule for debts for the payment of taxes. The regulations provide, in part, as follows: "[I]n the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law."

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

It is common practice for State and local governmental units in some States to undertake certain improvements to land, such as roads, curbs, gutters, sewer systems, etc., and to finance these improvements either through its general tax revenues or special assessments imposed on

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[1] There are some exceptions to the general rule that passive investment income is tax-exempt. For example, social clubs (sec. 501(c)(7)) and voluntary employees' beneficiary associations (sec. 501(c)(9)) are generally taxed on such income. Also, private foundations are subject to an excise tax of 4 percent (which the bill, as amended by the committee, lowers to 2 percent) on their net investment income (sec. 4941). An additional exception relates to debt-financed income (sec. 514), described below.

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

the land which the improvements are intended to benefit. The immediate funds for the improvements are provided by the sale of bonds secured by liens on the land. The bonds are then paid off either through the general tax revenues or the special assessments over a period of years.

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

Issue

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

The issue is whether this type of indebtedness should be treated as acquisition indebtedness.

Explanation of provision

This provision was sponsored by Senator Gravel. Under the provision, the indebtedness with respect to which a lien arising from taxes or a lien for special assessments made by a State or an instrumentality or a subdivision of a State is not to be aquisition indebtedness until, and to the extent that, an amount secured by the lien becomes due and payable and the exempt organization has had an opportunity to pay the the taxes or special assessment in accordance with the State law.[3] However, it is not intended that this provision apply to special assessments for improvements which are not of a type normally made by a State or local governmental unit or instrumentality in circumstances in which the use of the special assessment is essentially a device for financing improvements to an exempt organization's property.

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

This provision was requested by the Bishop Estate. It has potential application throughout the nation.

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

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[3] This amendment is intended to apply also to the definition of business-lease indebtedness in section 541(g). However, since that provision is proposed to be repealed by the committee amendment, no statutory amendment is made to it.

Revenue estimate

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

70. Extension of Private Foundation Transition Rule for Sale of Business Holdings (sec. 2514 of the bill)

Present law

The Tax Reform Act of 1969 imposed taxes upon certain transactions between a private foundation and its "disqualified persons" (generally, persons with an economic or managerial interest in the operation of that foundation). Among the transactions to which these taxes on "self-dealing" apply are the sale, exchange, or leasing of property (sec. 4941). The 1969 Act also added a provision which limits the combined ownership of a business enterprise by a private foundation and all disqualified persons and taxes any excess holdings which are not divested within a specified period of time (sec. 4943).

A transitional rule provided in the 1969 Act permits a private foundation to sell excess business holdings to a disqualified person if the sales price equals or exceeds the fair market value of the property being sold. This transitional rule was generally intended to allow private foundations and disqualified persons to disentangle their affairs and which was based on recognition of the fact that for many closely-held companies the only ready market for a private foundations holdings would be disqualified persons; in general it permits the sale of such excess business holdings within the transitional period during which the holdings would be permitted holdings. However, this transitional rule (sec. 101(l)(2)(B) of the 1969 Act) also provides that if the other requirements of the transition rule were satisfied, prior to January 1, 1975, a private foundation could have sold certain business holdings (which would have been excess business holdings but for the transitional and "grandfather" rules of section 4943) to disqualified persons even if those holdings were not, and would not become, excess business holdings (under sec. 4943).

Issue

The issue is whether it is desirable to provide a further transitional period for private foundations to divest themselves of certain "nonexcess" holdings in enterprises in which disqualified persons have a significant interest, if the foundation receives fair market value for such business holdings.

Explanation of provision

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

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

This provision was requested by Stackpole-Hall Foundation. It applies to any private foundation whose holdings in a business, as of 1969, amounted to less than 50 percent of the stock of the business but more than 20 percent. This provision is an extension of a special transitional rule in the Tax Reform Act of 1969; that special rule was originally requested by the Ford Foundation.

71. Private Operating Foundations; Imputed Interest (sec. 2515 of the bill)

Present law

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

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

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

Issues

The issues are:

(1) Whether a private operating foundation should be required to spend more than 3 percent of the value of its noncharitable assets for charitable activities;

(2) Whether a private foundation should be required to distribute for charitable purposes amounts of income imputed to it under section 483; and

(3) Whether a two-percent tax on net investment income should be imposed on libraries and museums if such organizations spend at least five percent of their noncharitable assets for charitable purposes.

Explanation of provision

This provision was sponsored by Senator Dole and will benefit operating foundations including libraries and museums.

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

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

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

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

72. At-Risk Limitation for Equipment Leasing

Present law

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

Issue

The committee's at risk limitation would apply to equipment leasing losses which arose under leasing transactions initiated either before or after the January 1, 1976, effective date of the amendment. It has been pointed out that this broad application of the at risk rule discriminates against preexisting leasing transactions which were set up before January 1, 1976. The issue is whether these preexisting leasing

transactions should be exempted from the at risk rule for equipment leasing.

Explanation of provision

This provision was sponsored by Senator Long.

Under this provision, the at risk rule will not apply to equipment leasing activities where the lease was in effect before January 1, 1976. This grandfathering rule will only apply where the taxpayer is able to establish the existence of a legally enforceable lease in effect on December 31, 1975, pertaining to the property from which losses are incurred after that date.

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

73. Corporations in Possessions of the United States (sec. 2519 of the bill)

Present law and committee amendment

Under present law, corporations operating a trade or business in a possession of the United States are entitled to exclude from gross income all income from sources without the United States, including foreign source income earned outside of the possession in which they conduct business operations, if they meet two conditions. First, 80 percent or more of the gross income of the corporation for the 3-year period immediately preceding the close of the taxable year must be derived from sources within a possession of the United States. Second, 50 percent of the gross income of the corporation for the same 3-year period must be derived from the active conduct of a trade or business within a possession of the United States.

The provision specifies that any domestic corporation which elects to be a section 936 corporation and and which qualifies under that provision can receive the special tax credit if it satisfies two conditions. First, 80 percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year must be from sources within a possession. Second, 50 percent or more of its gross income must be derived from the active conduct of a trade or business within a possession.

The amount of the credit allowed under this provision is to equal the portion of the U.S. tax on the domestic corporation attributable to taxable income from sources without the United States from the active conduct of a trade or business within a possession of the United States and from qualified possession source investment income. In determining the amount of tax attributable to the income from the active conduct of a possession trade or business or from qualified possession investment income, losses from other sources are to be taken into account.

Qualified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income in that taxable year).

To avoid a double credit against U.S. taxes if a corporation is eligible for the section 936 credit, any actual taxes paid to a foreign country (because it has different source rules) or a possession with re-

spect to the gross income taken into account for the credit are not treated as a creditable tax (under sec. 901 of the Code), and no deduction is to be allowed with respect to that tax.

The amendment establishing a new section 936 foreign tax credit for certain possessions income applies to taxable years beginning after December 31, 1975. The new rules on the dividends-received deduction apply to dividends received in taxable years beginning after that date regardless of when the earnings out of which the dividends were paid were accumulated.

Issue

Under the committee amendment, possessions corporations wishing to repatriate funds to their U.S. shareholders which are eligible for the dividends-received deduction need to await enactment of the new legislation in order to be assured that the dividends will in fact be entitled to the dividends-received deduction. In the meantime, the funds to be repatriated are often retained overseas in short-term investments often outside of the possession where the trade or business is being conducted. The earnings from these investments are exempt from tax under present law, but are made taxable under the commitee amendment for taxable year beginning after December 31, 1975, under the assumption that the funds may be freely repatriated back to the United States. Since this assumption is only true after enactment, the issue is whether the earnings should continue to obtain exemption from tax until such time as the provision is enacted.

Explanation of provision

This provision was sponsored by Senator Gravel. The provision treats income from any source outside the United States as qualified possession source investment income. Thus in effect that income is exempt from U.S. tax if the taxpayer proves to the satisfaction of the Secretary of the Treasury that the income from these sources was earned before October 1, 1976.

The provision will benefit most companies with tax holiday agreements in Puerto Rico. The Puerto Rican government expressed an interest in this provision.